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ABSTRACT

This instructor's guide is designed to accompany the text "Personal Money Management" and companion study guide (CE 023 968). It is intended to assist instructors in developing their own course outlines and teaching styles to suit the particular needs of their students. An introduction offers (1) an outline of the rationale behind the somewhat unconventional approach to money management taken in the text (the how-to approach), (2) a description of the major features of the text, (3) recommended and optional course schedules, and (4) a brief summary of the elements of this guide. A combination of lectures and student involvement in class discussion is suggested as the teaching approach. Each chapter (which corresponds to a like-numbered chapter in the text) contains all or some of the following ten sections: objectives, suggested approach, sample cases, additional topics for discussion, guest lecture ideas, additional materials and activities, answers to chapter questions, answers and discussion guide for case problems, sample test questions and answers, and transparency masters. Appendix materials in several chapters consist of longer versions of some procedures in the text. (YLB)

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Instructor's Guide

PERSONAL MONEY MANAGEMENT

THIRD
EDITION

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Preface

This guide presents a general approach to teaching a course in personal finance to junior college or college students, using *Personal Money Management* as a basic text. It offers a method whereby the text and additional materials can be coordinated to provide your students with an effective learning experience in personal finance. The guide was designed to assist instructors in developing their own course outlines and teaching styles to suit the particular needs of their students.

This introduction offers (1) an outline of the rationale behind the somewhat unconventional approach to money management that we have taken in our text compared to others in the field, (2) a description of the major features of the text, (3) recommended and optional course schedules, and (4) a brief summary of the elements of this guide.

In our approach to money management we seek to provide students with a set of tools they can effectively apply again and again throughout their careers as money managers. These tools are not mere facts and statistics; the latter would require considerable interpretation before being used and would soon become dated and useless. Instead, the text emphasizes *how* to make major decisions of a purely financial nature such as buying insurance, paying taxes, using credit, and making investments. We stress the *goals-strategies-implementation* approach, wherein students learn to define their needs and goals, design relatively sophisticated financial strategies, and implement their strategies by using the latest facts and concepts in order to obtain what is best for them rather than what is pushed hardest by the people selling financial products.

Two related areas of personal finance are given lesser treatment in this text. The first, commonly called something like home management or buymanship, usually pertains to home management, meal planning, wise consumer purchasing, shopping for bargains, and so on. Chapter 13 of this text, "Automobiles and Major Appliances," is the only significant discussion of the buymanship topic. The second is the newly emerging subject that deals with consumer legislation, awareness of consumer rights, and the avenues that may be used to remedy consumer/business inequities. This has been covered both as appropriate in the text (see "consumerism" in the index) and as a separate consumer agency appendix. We have chosen not to treat these topics in greater depth because we feel that, to do them justice, we would have to develop two more complete courses.

RATIONALE FOR THE TEXT

MAJOR FEATURES OF THE TEXT

The following summary of the major features of the text indicates how *Personal Money Management* can be particularly useful to both the student and the instructor.

- The five-unit structure enables instructors to organize their courses around several clearly defined strategies:
 1. Setting one's financial goals, planning a career, preparing personal financial statements, and setting up a budget
 2. Protecting one's income and assets through effective use of insurance (property, comprehensive liability, auto, health, disability, and life)
 3. Stretching one's income by means of planning; wise use of credit; and careful purchase of automobiles, consumer durables, and housing
 4. Investing income and assets properly for achieving one's goals
 5. Implementing the last three strategies with an eye toward one's later years (i.e., retirement and estate transfer)
- How-to techniques are presented for (1) accurate determination of one's needs for the various types of insurance, (2) budget planning and control, (3) coping with income taxes and their ramifications, (4) determining the future cost of using credit for immediate enjoyment of something one cannot presently afford, (5) designing an integrated strategy for one's investment program, and (6) projecting one's income needs.
- Objective approaches are taken regarding such areas as the investment potential of a cash-value life insurance program, the business attitudes characteristic of various financial institutions (including brokerage houses, insurance companies, and mutual funds), and personal use of a balance sheet and an income statement. *Personal Money Management* describes the financial industry's products without the biases inherent in many public pronouncements. The authors clearly discuss the advantages and disadvantages of each type of product, from the consumer's point of view. Furthermore, students are shown how to use their financial statements to determine their actual needs for the various products.
- Inflation and taxes are treated as factors that complicate all phases of one's financial program; the means of dealing effectively with them are discussed.
- Each chapter of the text is short enough to be a single reading assignment and is followed by questions designed to test the students' comprehension of the main concepts involved. (The answers to these chapter questions are given in this guide.)
- Student-oriented case problems dealing with the types of financial decisions students are likely to have are presented at the end of each chapter. These problems are designed to make personal finance a relevant topic while the students are taking your course. (The answers to these case studies are given in this guide.)
- In a continuing case study at the end of most chapters, the student helps Chuck and Nancy Anderson develop their financial program. This problem-solving activity will enable students to put their skills to work

in a realistic family situation and thus anticipate the financial decisions they will probably have to make during their lives. (The answers to this case study are given in this guide.)

- Each chapter contains a bibliography that provides sources for student research and in-depth study.
- A glossary of terms at the end of the text and a vocabulary list at the end of each chapter include those terms with which your students should become familiar.
- The Social Security addendum at the end of the text provides the information students will need when projecting what their income needs will be at various stages in their lives.
- The compound interest tables at the end of the text are to be utilized throughout the course in such varied situations as determining the effect of inflation and investments on one's life insurance needs, developing one's investment strategies, and projecting one's retirement income needs.

The basic approach of the instructor in the classroom should probably be a combination of lectures and, if class size permits, student involvement through class discussion of the Chuck and Nancy case study. (This case study is no longer structured as a cumulatively developing situation, and so there is no final summary of it at the end of this guide as there was in previous guides.) Additional suggestions for classroom activity are outlined in this guide. These include class evaluation of such things as a corporate annual report, a typical property insurance policy, and a real estate syndicate's offering circular.

The schedule in Table A shows the approximate number of class sessions per chapter that we recommend for both semester and quarter courses earning three units. This design is suggested in order to emphasize each topic according to its importance in one's overall financial program. There is enough material in the text and study guide for a full semester's work. If you are on the quarter system, we recommend that you not omit any topic, but rather cover each subject on a less intensive basis—assign all the reading in the text, but require fewer exercises, present fewer lecture examples, and pursue fewer research problems.

We recommend that the chapters be followed consecutively, to maintain the logical structure of the strategies outlined in the preceding section. However, the following are the sequence prerequisites for the various chapters in the book.

- Chapter 1 ("Introduction") should always come first.
- Chapter 5 ("Insurance Principles") should always precede any of Chapters 6 through 9.
- Chapter 10 ("Federal Income Taxes on Individuals") should always precede any of Chapters 11 through 20.
- Chapter 15 ("Investment Principles") should always precede any of Chapters 16 through 20.

COURSE SCHEDULE

- Chapters 21 ("Retirement") and 22 ("Transferring Your Estate") can be omitted if the class is entirely composed of young students more interested in immediately relevant issues. However, when included, these chapters should come last.
- Chapters 2 ("Your Career and Income") and 13 ("Automobiles and Major Appliances") could probably be omitted for a night course taken by experienced adults.

For the instructor who prefers to begin the course with the topics in Unit III, we recommend the following chapter sequence: 1 through 4, 10 through 14, 5 through 9, 15 through 22.

TABLE A
RECOMMENDED SCHEDULE

Unit	Chapter	Topic	Number of Class Sessions per Chapter	
			Semester	Quarter
I	1	Introduction to Personal Finance	1	1
	2	Careers and Income	1	1
	3	Record Keeping and Financial Statements	2	1
	4	Budgeting	2	1
II	5	Insurance Principles	1	1
	6	Property Insurance	2	1
	7	Comprehensive Liability and Auto Insurance	3	2
	8	Health Insurance	2	1
	9	Life Insurance	3	2
III	10	Federal Income Taxes on Individuals	3	2
	11	Borrowing and Banking	2	2
	12	Consumer Credit	2	1
	13	Automobiles and Major Appliances	1	1
	14	Housing	2	2
IV	15	Investment Principles	2	2
	16	Fixed Dollar Investments	1	1
	17	Stocks and Bonds	6	3
	18	Securities Markets		
	19	Mutual Funds and Other Professional Management	2	1
	20	Real Estate	4	2
V	21	Retirement	1	1
	22	Estate Transfer	2	1
TOTAL			45	30

CONTENTS OF THE INSTRUCTOR'S GUIDE

Each chapter in this guide corresponds to the chapter with that number in the text. Each chapter in the guide is divided into the following ten sections, some of which are not covered in every chapter.

- *Objectives* point out specific goals for instructors to keep in mind as they explain, amplify, and reinforce material from each chapter. These objectives correlate with those given the students in their *Study Guide*.

- *Suggested approach* provides (1) an overview of the philosophy behind the structure of each chapter and (2) the material to be covered, in the sequence recommended, to accomplish the objectives.
- *Sample cases* can be used as lecture anecdotes, additional classroom case discussions, or as ideas to prompt the use of the instructor's own experiences. Most are based on the authors' personal experiences.
- *Additional topics for discussion* provide additional ideas beyond the basic suggested approach.
- *Guest lecture ideas* provide some guidance for instructors who wish to bring in outside help in areas where they believe their own background is inadequate.
- *Additional materials and activities* provide the instructor with sources of additional teaching aids, ideas for classroom or research activities, and, in some cases, further background for a particular topic along with suggested lecture examples.
- *Answers to chapter questions* outline the key concepts that are sought in the questions.
- *Answers and discussion guide for case problems* provide material for the instructor to use to coordinate classroom discussion of both the student-oriented case problem and the Chuck and Nancy case study. It would be especially helpful to your students if you would go over with them the additional information on Chuck and Nancy contained in the guide.
- *Sample test questions* (both objective and essay) and *answers* serve as a resource for quiz material. (The questions may be duplicated from this guide for class use.)
- *Appendix materials* have been added to several chapters. For example, the longer procedures for determining disability income needs and investment needs have been appended to Chapters 8 and 15, respectively, in case you prefer to use them rather than the shortened versions in the text.
- *Transparency masters* provide blank forms to be used in following the procedures outlined in the text and additional resource materials such as a sample home buying form from an escrow company. These transparency masters can be used in lecture presentations or can be duplicated for class use (although most of them are available also in the *Study Guide*).

In all, there is probably more material in this guide than can be used in a single term, thus enabling the instructor to select that which meets the needs of the students and fits the style of the course being taught.

1 • Introduction

After studying this chapter, the students should be able to:

- Look for how their emotions and values are reflected in their financial decisions.
- Describe the interrelationships between goals, personal assets, and financial resources.
- Explain the importance of money management.
- Express their financial goals. (The order in which they will pursue them may change as they read the text.)
- List and explain the three strategies of money management.
- List and explain the functions of a money manager.
- Discuss the difference between inflation and deflation.
- Discuss the causes of inflation and the difficulty in projecting future inflationary rates.

OBJECTIVES

We have found it useful to begin the course with a discussion of money, putting it in proper perspective. To some, money and the things it can buy are much more important than to others (in fact, there will probably not be unanimity among class members as to its importance); but everybody needs money—it is essential in our society. At this time, you might stress to the class that, while money is important, it should not be allowed to become all-important. Also, point out to your students that learning to manage money comfortably will enable them to deal effectively with its importance without allowing it to rule their lives.

In the text we avoid saying what emotional reactions people *should* have toward money or what values they *should* hold. We consider these emotions and values the exclusive province of each individual and therefore refrain (as best we can) from imposing our opinions on others. This restraint should not be taken as a signal from us to avoid discussion of this area. On the contrary, such discussions help students become more aware of their own feelings and values and the range of feelings and values possible. Indeed, a significant portion of class discussion should be spent on this area.

To avoid rambling and inconclusive discussions, we suggest that you structure the discussion so that, as emotions or values are expressed, they are identified as such. Once a fairly extensive list of each category has been developed, attention might be turned to differences between values and emotions and how emotions and values are probably derived. Finally, time should be spent discussing the impact of advertising in this area. Again, if the discus-

SUGGESTED APPROACH

sion can be kept on a personal plane, it probably will have more meaning to the students.

Once you have satisfied yourself that this area has received adequate treatment, it will be time to begin discussing the more tangible aspects of this text. Money management will most readily be accepted as a valid activity if there are visible rewards. Therefore, once your class has put money in its proper perspective, you might direct your students' thinking toward an analysis of the interplay among goals, personal assets, and financial resources. We suggest treating two aspects of this interplay in depth:

1. *Financial goal setting.* Help them define goals specifically in terms of the desired amount of money needed and when it is desired—next week, three years from now, age 30, and so forth.
2. *The money management process.* Help them to realize that, as a result of this course, they will be able to manipulate their financial resources to achieve their financial goals.

The section on inflation and deflation has been included because of the increasing impact of inflation on everyone. In covering this area, we suggest you make sure your students understand that:

1. Price increases due to inflation are different from those due to product or service quality improvements.
2. There is more than one probable cause of inflation.
3. The process used by the government to measure inflation is by no means scientifically precise.
4. It is difficult to use historical experience to predict the future inflationary experience.

The text has been designed to correspond with the three basic strategies of money management: (1) protecting what you have, (2) getting the most out of your income, and (3) increasing your total income. An effective means of demonstrating how money management works might be to begin by discussing briefly the topics of each strategy. We suggest that you conduct a brief tour of the text, elaborating on the discussion found in the preface.

For example, Chapter 1 introduces the concept of money management: what it is, how it works, and what it can achieve. Chapter 2 deals with income and its major source: jobs and careers. Chapter 3 is concerned with taking inventory and getting organized. Chapter 4 is devoted to budgeting. Note that the opening chapters of Units II and IV provide the general insights and tools necessary to deal with the specifics covered in those units.

Finally, you might lead into a discussion of the planning, directing, and controlling skills; for it is their effective application that will be the end result of taking this course. Much of Chapters 1, 2, 3, 4, 5, and 15 are concerned with planning and to some extent with directing and controlling. The remaining chapters deal with planning as it relates to a specific topic and delve more deeply into the tasks of directing and controlling.

GUEST LECTURE IDEAS

1. Full treatment of inflation is not possible in a text on personal money management. Nevertheless, it represents one of the most vexing problems facing personal money managers today. You might invite a colleague from the economics department at your school to address your class on the

causes of inflation. This person may want to take issue with some of our comments on inflation in the chapter. Should make an interesting discussion.

2. You might canvass your colleagues in the psychology or sociology departments to determine whether any of them has done research on the psychological or cultural aspects of money. Surprisingly enough, money's role in these areas has not received much scrutiny. Therefore, it would only be good to invite someone as a guest lecturer if he or she has research experience in this area.

Three of the recommended books for this chapter are relatively short, easily understood discussions of major economic phenomena as they impinge on our lives. The Goldberg and Lewis book, on the emotional aspects of money, is of equal value, from another perspective.

There are no questions for this chapter. We feel that the case problems adequately cover the concepts presented.

Student-Oriented Case Problems

We have not attempted to provide answers for the first two Chapter 1 case problems. The questions are so subjective that there are really no correct or incorrect answers. The problems were included in the text to give students a perspective on their personal feelings toward money and a measurable starting point from which to learn to manage their own financial affairs. In your comments on their answers to these questions, you might point out how the students have or have not applied the concepts presented in the chapter.

Appropriate responses to the third case problem include:

- The list is not extensive enough to be representative of the general category of consumer prices.
- No information has been provided about weighting the various items in the index.
- No information about product improvements has been provided or a method of separating this consideration out of the price increases shown between 1970 and 1980.

Chuck and Nancy Anderson An Introduction

There are no specific questions or issues to resolve for the introductory case discussion presented in the text.

At this point it is important to help your students identify with the Andersons. You might point out to those who are not married, do not have dependents, or are not in their thirties that such circumstances are probably not far away. Stress that the money management concerns reflected in the Chuck and Nancy case problems are important because of what the students can expect in life rather than unimportant because they have not yet faced them.

ADDITIONAL MATERIALS AND ACTIVITIES

ANSWERS TO CHAPTER QUESTIONS

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

2 · Your Career and Income

OBJECTIVES After studying this chapter, the students should be able to:

- Describe some of the basic causes for differences in incomes—type of work, education, experience, geography, discrimination, luck, ability, and drive.
- Make a preliminary determination of important career objectives—income, status, career in relation to personal life, use of personal abilities, security, personal growth.
- Select careers that fit their personal objectives.
- Locate jobs within their career choices.
- Describe the basic procedures involved in job search, résumé writing, and interviewing.

SUGGESTED APPROACH The material in this chapter is not academically difficult, but it is surprising how many people do not intelligently make career choices.

Although the student will probably find the discussion on differences in incomes to be quite interesting, perhaps the most important messages to get across are the following:

1. Probably the most important determinant in career satisfaction is enjoying what you do. If you dread Mondays and look forward to the weekends, you'll be unhappy five-sevenths of your life. Evaluation of personal experiences as well as the various preference tests are good approaches to understanding what career is likely to be satisfactory.
2. If you enjoy what you do, you are more likely to be good at it and to work hard. Thus, you should be able to command top pay for the career you are in.
3. It is almost impossible to satisfy completely every career objective. If a job is easy and fun, it may not challenge you to grow. If a job does not require personal mobility, you will lack the enrichment that a diversity of geographic experiences can bring. If a career is exceedingly popular, there will probably be more qualified applicants than jobs available, thereby keeping a lid on pay increases. Students will have to make compromises and, to optimize their career choices, carefully rank objectives, with the idea of fulfilling the top priorities and compromising on the rest. The task is not easy because few people know themselves well except through personal experience or with the help of a patient counselor trained in personal psychology.

4. Most people give little thought to career choice but just drift along a path of least resistance. Someone who does give careful, long-range thought to a choice of careers is likely to be more satisfied than most.
5. Keep in mind the importance of an income level above the national median if you want to have a chance to be a money manager. Otherwise, you'll almost be forced into working from paycheck to paycheck right up to retirement.

The latter part of the chapter on finding and landing a job is an overview to help the students see the whole process and the important steps within it. Most students would benefit greatly from in-depth study of the materials on career search found in the placement office or from reading some of the material suggested at the end of the chapter. It would also be useful to have those students looking for work apply and interview for a job they are interested in and share their experiences in job hunting.

A useful exercise to get the students thinking about career preferences might be to have the class, in a discussion, develop an "ideal" set of job objectives. They probably won't agree, and so votes will have to be taken; you should ask those who dissent to ask themselves why they feel different from the group. (Don't make them feel guilty about "deviating"; it is usually healthy to have a strong set of personal values and personal direction.) Then have the students suggest various careers that might satisfy the priority list, and rate them. This won't be a scientific exercise, but it will get the students to understand the issues involved and spark thoughts about their own futures.

Ginny had always liked and done well in math and science and was very fond of animals. As a high school senior in 1963, she thought a career as a doctor or veterinarian might suit her. However, her parents did not support the idea. Being a vet would require too many years of graduate school and, to get an adequate return on her education, would have to be a full-time commitment afterward. A woman's first allegiance was to her family, they thought; her career should come second. Besides, women just aren't doctors or dentists or vets; women become nurses to marry doctors.

SAMPLE CASE

So, Ginny went to one of the top colleges to find a good husband and, meanwhile, study nursing. Nursing and teaching were careers women could always use if they ever needed to support themselves, Ginny's parents said. To fulfill the math-or-language requirement, Ginny studied French because the conventional wisdom was that one could always use language when traveling. Besides, what could women ever do with math?

After a year of poor grades in college chemistry, she wrote off nursing. She hadn't really had her heart in that career anyway. Her college major became economics. She wasn't sure what she would do with it, but at least she was very interested in it and felt it was something her parents would approve. Ginny respected her dad's success in business and thought maybe he'd genuinely appreciate her interest in economics.

Midway through college, Ginny met a science major, whom she went steady with. She eventually talked him into taking some economics courses and even into getting a master's degree in business administration. They married before graduate school.

Ginny went on to get a master's degree in education. Graduate school in economics was out of the question because she lacked the required mathematical background. Besides, a teaching career would be compatible with having a family. The hours and vacation schedule were convenient; she could leave the career for some years without becoming technologically obsolete; and she could always go back to it, if she needed to work.

Because Ginny was determined to do everything well, she became one of the most respected teachers in the high school. She taught mostly history, but the course she found the most satisfaction from teaching was economics. After she had children, she taught only half-time.

By her early thirties Ginny realized she wasn't getting the satisfaction out of her job that she needed. Her parents liked her career, but only because it allowed Ginny time to be a mother. She gave serious thought to following her dad's investment interests and buying run-down houses to fix up and sell (a successful strategy in the late 1970s), but he discouraged this as requiring too much time and physical effort. Even Ginny's husband, by now a very successful entrepreneur himself, had his doubts.

Eventually, Ginny realized she wanted a career where she could work with people with similar interests and where she could find challenges and personal growth. She doubted that teaching the same courses for the next 30 years and having daily interpersonal relationships mostly with teenagers would meet these criteria. But the hours and vacation schedule did give her time to enjoy her family.

She started seriously exploring the possibilities of graduate work in business, psychology, or medicine. Could part-time careers be possible in these areas? How much catch-up schooling would she have to take in math or science? Would she be able to get into a good graduate program at age 35?

Ginny had many regrets about the past, and these emotions made it difficult to look clearly to the future. She hoped it wasn't too late to change careers. After all, many of her peers had 5 or 10 years' experience behind them. Even Ginny's husband shared her dissatisfaction. It was most important to him that she be happy, no matter what career choice that involved.

Discussion Points

1. Ginny looked for direction from outside (parents, husband, contemporary mores) rather than from within herself. (Note that Ginny's husband also was outer directed, by Ginny.)
2. Ginny may have burned her bridges behind her by not following on with her natural interest in math in college.
3. The problems of postponing career decisions too long.

ADDITIONAL TOPICS FOR DISCUSSION

Show your students the statistics in Table 2-A. Which sectors show the greatest job growth? Which seem to show the least job security? Might that job security risk be higher for a blue-collar worker or for a college graduate?

Should the student use such job growth studies to help select a career? Why or why not? Are the figures of any real use? (Note: Most studies of job growth, even in narrowly defined career fields, tend to be accurate only for

TABLE 2-A
AVERAGE ANNUAL EMPLOYEES BY INDUSTRY
(in millions, rounded to nearest 100,000)

Year	Mining	Construction	Manufacturing	Transportation, Public Utilities	Wholesale, Retail Trade	Finance, Insurance, Real Estate	Service, Miscellaneous	Government
1955	.8	2.8	16.9	4.1	10.5	2.3	6.3	6.9
1973	.6	4.0	20.1	4.7	16.7	4.1	13.0	13.7
1977	.8	3.8	19.6	4.6	18.3	4.5	15.3	15.2

SOURCE: U.S. Bureau of Labor Statistics.

a few years at best. The economy and technology change, but, more importantly, the supply-demand cycle is poorly understood and misinterpreted. Generally, if a person is patient, within a few years most individuals should land a job in their selected career, even if it is temporarily overrun with job seekers facing a shrinking employment field.)

1. *Personnel officer*, or someone who regularly interviews and hires new employees.
 - a. Problems faced by the potential employer (what it's like to interview and hire). How successful is he or she? Why?
 - b. What they look for in potential employees.
 - c. What screening process is used? How might this differ from employer to employer? Does the job candidate need to know about these differences?
 - d. What information is kept in a personnel file?
 - e. How can an individual influence his or her career path?
2. *College placement counselor*.
 - a. Common mistakes of job seekers (this will provide interesting case studies to liven up the lecture).
 - b. Services available at the college: counseling, testing, library materials, and on-campus interview sign-ups.

1. Have students go through one job interview with an organization they might be interested in, perhaps only for a summer job or part-time job. Then have them write a one-page critique of the process—what they did and didn't handle well.
2. Have the students list the ideas they have for a career and then have them describe where the idea came from and how they feel about it.
3. Have the students scan the federal government's *Occupational Outlook Handbook* and list the training required and average starting salary for the top five careers they are interested in. Based on this data and the description of the work done, have them rank the top five in order and explain why they ranked them in that particular order.

ADDITIONAL MATERIALS AND ACTIVITIES

4. The transparency masters at the end of this guide can be reproduced for student practice at filling out job applications and gathering the information needed. One application is for an office position; the other is for a professional position with a major accounting firm. The interviewer forms will also give the students some insight into the employer's perspective.

ANSWERS TO CHAPTER QUESTIONS

1. Personal interests and preferences, amount of money one can earn, how career fits into your desired lifestyle, personal abilities, personal growth desired.
2. (Student should carefully analyze himself or herself.)
3. (Student should carefully analyze himself or herself.)
4. Job counselors such as at the college placement office, career guidebooks, personal contacts, want ads.
5. To get an interview.
6. You should learn about the job and sell yourself to the interviewer.
7. This is usually the final step before you are offered a job. Not only do you want to impress the employer on why you should get a job offer, but you also want to find out whatever you will need to know about the job in case you have to decide whether to accept or reject the offer.

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

1. No.
 - a. Irene's resumé needs to show more of her business background and less of her music career, except to the extent such work showed her personnel or general business abilities and experience. Cut the resumé to one page.
 - b. She should have talked to several people in the career field she's considering. This should give her some better leads than a blanket mailing.
 - c. Select fewer than 100 companies. There's no way she can personalize each one and tailor it to the particular firm. Blanket mailings look like blanket mailings and are generally received with little interest.
 - d. She also should check out the placement office or an employment agency or the want ads.
2.
 - a. He's gaining no experience nor learning any useful knowledge while he bides his time.
 - b. He might need certain undergraduate courses to prepare for graduate school, should that be the direction he chooses.
 - c. Once he leaves college, he'll lose the help of the placement office.
 - d. A full-time job as an office clerk may not look very impressive on his resumé when he does go for a different career.
 - e. If his first career choice is not satisfactory, he can always change, and he will have learned something from the experience.
3. Another exercise for student self-examination.

Objective Questions

SAMPLE TEST QUESTIONS

Circle the letter of the correct answer to each question.

1. Individual skill and effort are most likely to be an important factor in determining the level of pay in which of the following jobs?
 - a. Part-time clerk at a hamburger stand
 - b. Computer salesperson
 - c. Unionized factory worker
 - d. Public high school teacher
 - e. Fire fighter
2. Compared to other workers, workers who have higher levels of education and work at jobs requiring those levels of education are likely to
 - a. earn more money
 - b. get laid off more often
 - c. earn less money
 - d. have more control over job transfers
 - e. require less continuing education during their careers
3. A person's highest earning years typically are between ____ and ____ years of age.
 - a. 16, 25
 - b. 25, 34
 - c. 34, 45
 - d. 45, 54
 - e. 60, 65
4. The lowest levels of income and cost of living are found in
 - a. Alaska
 - b. New England
 - c. the West Coast
 - d. Honolulu
 - e. the South
5. Compared to 1960 when the median income of black families was 55.3 percent of white family income, 1977 figures show
 - a. no significant change
 - b. a modest improvement for blacks
 - c. a modest decline for blacks
 - d. major improvement (to over 90 percent)
 - e. a loss due to inflation
6. American families in the top fifth of incomes earn about five times that of families in the bottom fifth. The children of such wealthy families tend to maintain that gap over children of the bottom fifth.

True

False

7. The choice of a satisfactory career will most likely come from
- a. analyzing your own preferences and abilities in relation to available careers
 - b. drifting along with blind luck
 - c. following the advice and urging of parents and professors
 - d. eliciting the experience of friends and acquaintances
 - e. focusing on the highest paying jobs available through the placement office
8. Careful analysis of careers during your college years will probably result in a 98 percent chance of staying with your career choice the rest of your working life.
- True False
9. What result should you generally seek from your first interview with a potential employer?
- a. An invitation to a second interview
 - b. A job offer
 - c. Advice on improving your chances for another job
 - d. Complete information about the job for which you were applying
10. You should learn about the employer's vacation and fringe benefit policy
- a. from the firm's annual report
 - b. at the first interview
 - c. at the second interview
 - d. after you have written a letter accepting the job offer
 - e. by writing the personnel office

Essay Questions

1. What are four reasons why many people wind up in careers they decide to leave after only a few years?
2. What are the career advantages to education?
3. List seven factors that go into determining one's likely level of pay, and briefly explain their influence.
4. What two things are most important to know before you make a career choice?
5. Briefly summarize, in sequence, the process of finding and landing a job, including a list of at least three potential sources.

Objective Answers

ANSWERS TO SAMPLE TEST QUESTIONS

1. b The other occupations utilize standard wage scales.
2. a The other answers are probably the opposite of what happens to better educated workers in jobs suited to their educational attainment.
3. d
4. e
5. b (to 60.6%)
6. F By the second generation, the average gap has been found to be only 1.75 times.
7. a
8. F People understand themselves better and the implications of certain career choices as they gain experience. Also, people's values change.
9. a "b" and "c" are unrealistic; "d" can wait until the second interview.
10. c

Essay Answers

1. Lack of planning; bad luck; poor understanding of themselves; blind acceptance of parental advice; the conviction that *only* money or *only* job satisfaction mattered—that there are no compromises; poor understanding of the career's demands and benefits.
2. Increases likely level of pay; reduces chances for unemployment; qualifies person for potentially more interesting and challenging jobs.
3. Education, geography, type of work, experience, discrimination, skill and perseverance, family heritage, luck. (See chapter discussion for influence.)
4. Your needs and abilities and the costs/benefits of the career.
5.
 - a. Search want ads, placement office, talk to contacts.
 - b. Prepare resumé, possible cover letter.
 - c. Obtain appointment for first interview and learn about the firm.
 - d. First interview, possible follow-up letter.
 - e. Second interview.
 - f. Evaluate job offers, perhaps visit with potential co-workers.
 - g. Write thank-you letters to all firms who offered second interview and/or actual jobs.

**TRANSPARENCY
MASTERS**

1. Application for Office Position
2. Personal Data Sheet (application for professional position with a major accounting firm)
3. Telephone Reference Check
4. Record of Interviews

3 · Your Financial Starting Point

After studying this chapter, the students should be able to:

- Explain how they would establish a personal or family record-keeping system that contains the information necessary for making important financial decisions.
- Construct their own personal income statements.
- Construct their own personal balance sheets.
- Explain the use of the income statement and balance sheet in planning, directing, and controlling a family's financial affairs.

OBJECTIVES

This chapter is intended to develop a foundation upon which your students can build as they learn to use the strategies developed in the other units of the text.

SUGGESTED APPROACH

Perhaps the most important learning experience in this chapter is the preparation of one's own financial statements. We have found it helpful to work through, with our classes, several examples of the procedures used in constructing personal balance sheets and income statements. Because it is extremely important that students establish their own financial starting point at the beginning of the course if they are to derive full benefit from it, we suggest that you require each student to complete a personal balance sheet and income statement before you move on to Unit II. This will enable students to relate personally to the decisions discussed throughout the course. Also, they will need to use their financial statements while reading Chapters 4 and 5.

You might have your students fill out these forms as a homework assignment (not necessarily to be turned in) for Chapter 3. Blank forms for both the balance sheet and the income statement are provided in the *Study Guide* (as well as text Table 3-1, "Contents and Operational Checklist for Each File of Financial Records," and text Figure 3-1, "Personal Information Sheet") and also at the end of this guide.

Because all financial decisions affect the individual's balance sheet and income statement in one way or another, it may be helpful to begin emphasizing now that, as they go through the course, each student should make financial decisions as the need for them arises and modify their financial statements to reflect the decisions they have made.

If you can take the time to help your students work through the George and Sybil Barnes example and the Chuck and Nancy case problem for this chapter, they should have ample opportunity to understand how each item is determined.

As a companion to the record-keeping system discussed in the text, the calendar format shown in the transparency masters at the end of this guide might be a worthwhile tool to introduce to your students. This timetable is also provided in the *Study Guide* as part of a personal money management exercise.

ADDITIONAL MATERIALS AND ACTIVITIES

Table 3-A provides data for comparing one's personal balance sheet to the national aggregates. Note that 1979 figures would show much higher percentages in real estate market values and lower percentages in stocks.

TABLE 3-A
NATIONAL BALANCE SHEET—ASSETS
(in current prices)

Asset Category	1900	1929	1933	1955	1968
Cash Equivalents (currency, demand deposits, bank deposits)	13%	12%	14%	17.1%	15.8%
Bonds and Mortgages					
Mortgages	6	7	8	6.8	9.3
U.S. bonds	1	2	5	14.2	7.0
Municipal bonds	2	3	4	2.4	2.9
Corporate, other	5	6	8	3.5	3.9
TOTAL	14%	18%	25%	26.9%	23.1%
Common and Preferred Stock	14%	29%	21%	19.0%	23.8%
Real Estate					
Nonfarm land	11	9	8	7.4	9.8
Structures	29	24	25	24.1	22.7
Farm land and buildings	18	7	7	5.4	4.7
TOTAL	59%	40%	40%	36.9%	37.2%
Less: Mortgages	6	7	8	6.8	9.3
Or: TOTAL EQUITY	53%	33%	32%	30.1%	27.9%
PRIVATE TOTAL (100%)	\$99 ^a	\$635 ^a	\$483 ^a	\$1,913 ^a	\$4,275 ^a
Plus: Public land	6%	3%	4%	2.5%	3.5%
Public and institutional structures	3	4	6	10.2	12.0
Equipment (private)	13	13	11	14.5	14.2
Inventories (private)	10	6	4	6.4	5.1

SOURCE: U.S. Department of Commerce, Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1970*, Part 1 (September 1975), p. 253.

NOTE: Totals have been italicized as the numbers to focus on.

^aBillions of dollars.

ANSWERS TO CHAPTER QUESTIONS

Because the case problem fully covers the major concepts in this chapter, there are no questions.

Student-Oriented Case Problem

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

Richard's Income Statement

Income		
Salary	0	
Other (gift)	\$5,000	
TOTAL INCOME		\$5,000
Living Expenses		
	<i>Fixed</i>	<i>Variable</i>
Tuition	\$1,200	
Room and board	2,150	
Books and supplies		300
Gas and car maintenance		950
Car insurance	500	
Miscellaneous		\$1,500
Subtotal	\$3,850	\$2,750
TOTAL EXPENSES		\$6,600
Net Loss		(\$1,600)

Richard's Balance Sheet

Assets		Liabilities	
<i>Monetary Assets</i>			
Cash		Unpaid Bills	
Checking account	\$ 180	Insurance premium	\$ 500
		Bookstore bill	40
Total monetary assets	\$ 180	Total unpaid bills	\$ 540
<i>Fixed Assets</i>		<i>Loans</i>	
Automobile	\$1,400	Education	\$1,600
Personal property	2,400	Total Loans	\$1,600
Total Fixed Assets	\$3,800	TOTAL LIABILITIES	\$2,140
TOTAL ASSETS	\$3,980	Richard's net worth	\$1,840

Note: Since Richard spent more money than the \$5,000 he had to start out with (his parents' gift), he had to borrow money to make ends meet. This borrowed \$1,600 shows up as a liability on Richard's balance sheet. The loan does not show up anywhere as income because he has to repay it. In effect, he is borrowing capital—in lieu of selling off assets—to provide himself with the money he needs for living expenses.

Chuck and Nancy Anderson
Their Balance Sheet and Income Statement

1. The Andersons have no major financial problems. However, the following are some issues worth noting.

- a. The Andersons saved \$2,696 in 1979, or about 8.4 percent of their gross income. (To be technically correct, one should also include the principal payments on loans as savings as well.) This is above the 6 to 7 percent typical national average, especially for a couple in their family raising years.
- b. This rate of savings is apparently abnormal for the Andersons because their balance sheet shows the following:

Total monetary assets	\$15,700
Unpaid bills	(320)
Margin loan	<u>(1,500)</u>
Net investments	\$13,880

(There are no fixed assets of a strictly "investment" nature).

Either the Andersons had an unusually good year at controlling their spending or someone got a raise that hasn't yet been incorporated into new spending habits.

- c. Perhaps the \$1,100 capital loss last year was due to bad luck, or maybe it reflects an investment program ruled by emotion (buy when stocks are up and sell after the bear market gloom sets in) rather than by reason.
 - d. The Andersons tend to use expensive consumer credit to buy durable goods, even though they have assets in their portfolio that have lower interest rates and could be liquidated for these purchases.
 - e. They will probably have to pick up the pace of their investment accumulation, to meet the college needs of their two children plus their own retirement needs.
2. The factor that has contributed most to their positive financial position appears to be the equity they have built up in their home. This accounts for over one-half of the Andersons' net worth.

Circle the letter of the correct answer to each question.

**SAMPLE TEST
QUESTIONS**

1. Of the following, the best place to keep your insurance policies is
 - a. at home, provided that a list of them is kept in your safe-deposit box
 - b. in your safe-deposit box
 - c. with your insurance agent
 - d. in a fireproof box
 - e. They can be discarded since they can always be replaced.
2. Herman had \$14,000 in salary, \$13,800 in living expenses, \$500 in his checking account; he owned a \$6,000 car and had \$1,200 in outstanding bills. His amount remaining for savings last year on his income statement was
 - a. \$5,300
 - b. \$500
 - c. \$200
 - d. -\$700
 - e. -\$1,000
3. Your financial profit or loss for the year is clearly laid out in your
 - a. checkbook
 - b. income tax return
 - c. balance sheet
 - d. income statement
 - e. assets minus liabilities
4. An income statement is a plan for the future, while a budget is a report on the past.

True False
5. Your assets minus your liabilities equals your net worth.

True False
6. How often should financial records be discarded?
 - a. Every seven years
 - b. Every four years
 - c. Annually, except canceled checks, which should be kept seven years
 - d. When the files get too bulky
 - e. Depends on type of item
7. Marianne spent \$4,000 on rent, \$3,600 on food, \$2,400 on clothes; she invested \$3,000 in stocks, spent \$500 on medical bills covered by her insurance, and spent \$7,000 on other living expenses. Her total living expenses last year were
 - a. \$20,500
 - b. \$20,000
 - c. \$19,500
 - d. \$17,500
 - e. \$17,000

8. Bruce has \$15,000 in monetary assets, \$18,000 in a profit sharing plan (which he can draw out when he retires in 10 years), a \$10,000 car, \$1,000 in bills he owes, and each year he receives \$1,000 in dividend income. His net worth is
- a. \$44,000
 - b. \$43,000
 - c. \$42,000
 - d. \$26,000
 - e. \$24,000
9. Linda owns a home just like the one next door, which recently sold for \$70,000; she paid \$40,000 for hers five years ago. Her mortgage balance started at \$32,000 but now is \$29,000. Her other assets are a car worth \$6,000 and \$2,000 in cash. She has no other debts. Her net worth is
- a. \$49,000
 - b. \$46,000
 - c. \$43,000
 - d. \$19,000
 - e. \$16,000
10. You can increase your net worth by
- a. showing a surplus on your income statement
 - b. making payments on your installment loans
 - c. having your assets increase in market value
 - d. (None of the above)
 - e. (All of the above)

**ANSWERS TO
SAMPLE TEST
QUESTIONS**

1. a This is most convenient and acceptable.
2. c $\$14,000 - \$13,800 = \$200$
3. d "a" and "b" are sources of information, but do not lay out a clear picture.
4. F The two definitions should be reversed to be true.
5. T The basic balance sheet equation.
6. e See Table 3-1, "operational checklist" column, for details.
7. e $\$4,000 + \$3,600 + \$2,400 + \$7,000 = \$17,000$
8. c $\$15,000 + \$18,000 + \$10,000 - \$1,000 = \$42,000$ (Dividend income is not an asset.)
9. a $\$70,000 - \$29,000 + \$6,000 + \$2,000 = \$49,000$
10. e See discussion in text.

**TRANSPARENCY
MASTERS**

1. Timetable for Financial Decisions
 2. Income Statement (blank form from text Figure 3-2)
 3. Balance Sheet (blank form from text Figure 3-3)
- All of these forms are also reproduced in the *Study Guide*.

4 • Budgeting

OBJECTIVES After studying this chapter, the students should be able to:

- Record expenses effectively.
- Forecast income and expenses.
- Set up a budget that controls expenditures but has flexibility.
- Plan expenditures in a way that removes guilt from spending and avoids family disputes.
- Plan expenditures so that there will be savings for meeting future expenses and achieving goals.

**SUGGESTED
APPROACH**

No one will try budgeting unless the results of budgeting are emphasized in a manner that seems real to him or her. It is as important to stress the psychological results of budgeting (e.g., being able to spend money without guilt) as it is to stress the tangible results (e.g., being able to purchase an expensive luxury item, a new washer and dryer, or a house). It may be a good idea to question your students about their frustrations with money. Some may not be able to get out of debt, always run out of money by the end of the month, do not know where their money goes, are critical of the way their spouses spend money, and so on. Generally, when people lose control over their financial lives, the principal reason is their failure to plan ahead on a realistic basis. Budgeting allows them to look ahead; but, unless they actually try to live on a budget, few people realize how this important benefit occurs.

Show how budgeting can enable them to surmount their problems because, by budgeting, decisions such as where, when, and how much money should be spent are made during a planning session at the beginning of the month—before the money is actually used. Explain that the value of the budget derives from its use not only as a planning tool and control mechanism but also as a record of past expenditures for tax and future planning purposes.

The importance of a mad money category should not be underestimated. Mad money provides a psychological and financial outlet for those who easily become irritated with regimentation. Each member of the family should be able to spend his or her allotment without restriction: without needing to answer for it to anyone else or to record the expenditures. Emphasize to your students that the mad money category is entirely separate from the miscellaneous category and that it should never be used as a catchall for expenditure categories that have gone over their limits.

Encourage your students to develop their own budgeting techniques and to share successful ones with each other. Make sure they know how to perform the following basic steps:

1. Set up budget categories.
2. Select the budget period.
3. Chart expenses.
4. Monitor expenses.

The *Study Guide* provides copies of the blank forms your students will need to use in setting up their own budgets: forms for forecasting income, short-term goals, long-term goals, and expenses; and the budget control sheet. (Instructions for their use are in Chapter 4 of the text.) Copies of these blank forms are also provided at the end of this guide for use as transparency masters.

It has been our experience that the results of budgeting cannot be fully appreciated until one has actually been on a budgeting program for a while. Thus, we suggest that you strongly encourage your students to give budgeting an open-minded, wholehearted effort before deciding whether or not it is appropriate for them. Try to have them do this while they are taking your class. Then you will be able to help them if they run into problems.

In addition to teaching your students how to use psychology to rally the family around the idea of budgeting, you must caution them to be patient. Encourage them to set objectives they can realistically expect the budget to accomplish. The first objective might be to get everyone to agree on how the money should be spent and to draw up a tentative budget. The second objective might be to get all the family members to record their expenditures. Finally, once the other two objectives have been accomplished, they can worry about whether or not they actually are living within the budget limits.

Finally, we do not pretend that Chapter 4 espouses the "one and only" successful budgeting technique available. Although one of the authors has used it successfully for 12 years, there are other systems. If you particularly favor one variation, by all means present it to the class (clearly specifying where it deviates from the one in the text); perhaps your personal enthusiasm for the system can win some "converts" to budgeting where the text system might fail.

1. Locate an enthusiastic person who has been operating under some kind of budget system for at least a year. Have that person make a short, informal presentation that lets the students see his or her *personal enthusiasm* for the budget process. Include:
 - a. What it was like before there was a budget.
 - b. What the perceived benefits of the budget are.
 - c. How other members of the family fit into the process and how they feel about it.
 - d. If you think it won't confuse the students, have the person explain the special nuances or mechanical details that seem to make that particular budget successful. *Sell* the budget process to the students so that they'll at least give it a try.

GUEST LECTURE IDEAS

2. Have a counselor from a local credit counseling agency or credit union talk to the class about the budget methods he or she uses to help people resolve their debt abuse problems, including:
 - a. Mechanical techniques
 - b. Psychological techniques
 - c. Success rates
 - d. What makes for a successful cure

ADDITIONAL MATERIALS AND ACTIVITIES

1. Have your students investigate local banks to see whether they will "spread" personal checks into prearranged categories as they do for many businesses. Determine whether such a bookkeeping service might be worth the price.
2. Have your students determine the price of immediate enjoyment. Give your class a specific budget situation, such as Alex and Karen's, and have them look at how much is allocated to savings and investment. Then have them select various fixed goods such as cars, appliances, a home down payment, and vacations and determine how long it would take to save for these goals by using the budget. Have your students compute the cost of achieving these goals both by budgeting for them and by borrowing for them.

Assume that at the end of each month the money in the savings and investment category is shifted to a savings account paying 6 percent interest from the day of deposit to the day of withdrawal. Further assume that if they had borrowed money to buy these goods instead of investing money for them, it would cost them 10 percent a year. Your students should subtract the interest earned from the cost of the item when considering the budget alternative, and add the interest charged by the lender to the cost of the item when considering the borrowing alternative. The cost of immediate enjoyment is the difference between the interest-adjusted costs for budgeting and for borrowing.
3. Have your students keep a record of their spending for a month and use this information to help plan their own budget programs.
4. Interview several people to find out what problems and successes they have had in budgeting their spending.

1.	Plus or Minus	Balance Forward	ANSWERS TO CHAPTER QUESTIONS
Housing	\$ 0	\$ 220	
Utilities	-17	13	
Food	-14	166	
Family necessities	+16	46	
Medical	-6	9	
Clothing	+30	90	
Automobile	-64	9	
Recreation and entertainment	+1	26	
Personal improvement	-72	40	
Short-term goal fund	+84	174	
Savings and investment	0	125	
Outlays for fixed assets	+20	40	
Mad money	+30	60	
Gifts	+78	108	
Church and charity	+2	22	
Life insurance	+80	100	
Contingency	+25	35	
Total	+\$193	\$1,203	

2. The food category is slightly overspent each month and might be revised upward about \$5 a month. Of course, Karen and Alex still have the option of reducing their monthly expenditures for food instead of revising the limit. Automobile is on target, as the insurance payments and license fees scheduled for January and February were anticipated to put this category in tight shape. A similar argument applies to the personal improvement category where two of three tuition fees have been paid by April.

There is no one correct answer as to which budget categories should be revised downward—that more or less depends on the individuals involved. We suggest that the family necessities category be revised downward in this case because the expenses here are small, regular, and fairly predictable; the surplus suggests that the category is probably overfunded. The contingency category surplus should be left for emergencies; it is not that big yet. The surplus in gifts will probably be more than used up during the next Christmas season.

3. There are many advantages to being on a budget. Three that the student might select are:
- It lets you spend without guilt because you and the other members of your family agree about where money should be spent in advance of the actual expenditure.
 - It serves as a record for tax planning and preparation.
 - It helps you save for large expenditure items instead of using costly consumer credit.

(Other answers involving "emotional insights" would also be acceptable.)

4. You should record charge account purchases as you make them, not at the end of the month. If you let the charges accumulate during the month without recording them, you may not know you have depleted a category until it is already overspent. By recording each transaction as it occurs, you will be aware of just how much you have left to spend.
5. It is better to allow negative entries than to incur the extra costs involved in paying for some items by installments. Such things as insurance premiums, if paid on a monthly basis, cost up to 12 percent more than if paid on an annual basis. Therefore, the expense category should be given some flexibility rather than force the family to assume a larger cost. Also, if a member of the family absolutely needs something during the month and cannot wait for the next budget period, it may be better to bend the budget than to postpone the expense arbitrarily, thereby potentially undermining the budgeting process itself.
6. Tear up the credit cards and put an amount of money regularly in a savings account for the major expenditures that you can plan for. Then spend the rest of the money as you please, either until it is gone or until the next payday comes.

**ANSWERS AND
DISCUSSION
GUIDE FOR
CASE PROBLEMS**

Student-Oriented Case Problems

1. No. A monthly budget would work. When monthly income and expenditures fluctuate so widely but not in tandem, it is extremely important to plan to meet larger expenses in coming months by saving income when expenses are low.

Janet's budgeted monthly average income should be \$381.

Total income composed of:

From parents ($\$150 \times 9$ months)	\$1,350
Summer job	1,500
School job ($\$80 \times 9$ months)	720
Scholarship grant	1,000
Total Annual Income	\$4,570
Average income per month ($\$4,570 \div 12$ months)	\$ 381

Her monthly expenses average \$331—\$50 less than her average monthly income. Therefore, at the end of the year she should have \$600 ($12 \times \$50$) that she could invest or spend as she sees fit.

Total expenses composed of:

Tuition ($\$140 \times 3$ terms)	\$ 520
Room and board ($\$450 \times 3$)	1,350
Books	180
Monthly transportation and personal expenses during school (9 months $\times$ \$220)	1,260
Monthly transportation and personal expenses during summer (3 months $\times$ \$220)	660
Total Annual Expenses	\$3,970
Average expenses per month ($\$3,970 \div 12$ months)	\$ 331

Janet should have an average surplus of \$50 a month. However, if she does not set up a budget, she may well run out of money during the

school year because she won't know how much money to save during the summer when she is making \$280 (\$500 income - \$220 expenses) a month more than she needs to live on.

2. Dale should set up a savings account to fund these major items in advance. The average monthly deposit would be calculated as follows:

auto license	\$ 75
insurance	680
Christmas	500
vacation	500
	\$1,755 ÷ 12 = \$146.25

The initial deposits may have to be larger, depending on when he starts his cycle.

His savings would amount to the following:

insurance	\$ 60
Christmas	30
vacation	30
TOTAL	\$120 plus interest earned on his savings account

3. The first clue to the need for a budget was the estimate Phil made of \$17,000 income and \$18,200 expenses, for a \$1,200 shortfall last year. The final realization came when there was no more credit available from the bank on the credit cards because they had so greatly outspent their income.

Phil's weekend planning session had the fatal flaw of not involving the other members of the family; Ellie should have been an equal participant in the process.

The four-point program could be improved by having a spirit of mutual agreement replace Phil's single-handedly determining budget deviations, Ellie's career plan, and the mode of entertainment to be allowed. The good points in the program are: locking up (or destroying) the charge cards, having a mad money category (though \$2 a week may be too tight), and recognizing that another income can help expedite a solution to the money crisis.

Chuck and Nancy Anderson **Setting Up a Budget**

1. The Andersons' average income per month after taxes is \$2,190.

Excluding the capital loss, the Andersons' annual income is \$33,330 (\$21,000 husband's salary plus \$12,000 wife's half-time salary and \$330 dividends). Subtracting taxes and Social Security in the amount of \$7,040 leaves them with a net take-home income of \$26,290. Dividing this by 12 gives them an average monthly income of \$2,190.

2. No.
3. They should reevaluate the budget categories over which they have some control (i.e., recreation, food, clothing, and outlays for fixed assets).
4. To avert quarrels, Chuck and Nancy should structure their budget to provide each of them with a mad money allotment that they can spend any way they wish without having to account for it.

**SAMPLE TEST
QUESTIONS**

Objective Questions

Circle the letter of the correct answer to each question.

1. You can make budgeting a successful and rewarding experience by
 - a. being sure that every penny is accounted for
 - b. borrowing funds to make up the difference if you overspend your budget in any month
 - c. involving the whole family in planning and operating the budget
 - d. entering all expenses at a set time each week (Saturday morning, for example)
 - e. having a sufficiently large number of budget categories to account for every spending detail
2. Entering charge account or credit card purchases as they are made, instead of when the monthly bill arrives, provides
 - a. greater expense control
 - b. more flexibility
 - c. less bookkeeping
 - d. simpler budget revisions
 - e. a better tax record
3. You should select a budget period equal to your job payment period no matter whether it is weekly, semimonthly, or monthly.

True False
4. Budgeting is of some benefit with regard to your income taxes.

True False
5. The fail-safe budgeting method cannot, under any circumstances, allow any expense categories to go negative.

True False
6. For all people, the budgeting process can be reduced to a highly rational exercise, where the same mechanical system will be successful for everyone.

True False
7. In times of 5 percent inflation one should adapt one's budget by
 - a. comparing actual spending and budgeted amounts on a category-by-category basis
 - b. adjusting the budget for each category upward by 5 percent
 - c. same as "b" but only if take-home pay also goes up by 5 percent
 - d. same as "b" but only for variable expenses

Essay Questions

1. Sarah's annual earnings were composed of a regular \$2,000 monthly salary and a year-end profit-sharing bonus. This bonus had amounted to the following percentages of monthly salary the previous five years: 100 percent, 50 percent, 200 percent, 0 percent, 100 percent. What should Sarah's monthly income budget be? Why?

2. Should one use national averages for your family type and size to set up an initial budget? What do you recommend?
3. What portion of the family life cycle makes the biggest budget demands? What helps meet these demands?

Objective Answers

ANSWERS TO SAMPLE TEST QUESTIONS

1. c If you do not get the whole family involved, they may not want to cooperate. Answer "a" is not good because it is often impossible to keep track of every cent. Too many budgets are abandoned because the books and the actual dollars on hand do not balance to the penny. Answer "b" defeats the purpose of the budget. Answer "d" is not good because if you wait a week to make your budget entries, someone will likely forget to enter a purchase or two. Answer "e," to be correct, would require an incredibly cumbersome number of categories.
2. a This is very important. If you wait until the monthly statement arrives, you may have far overspent a budget category without realizing it. The technique has nothing to do with "a," "d," or "e," and requires more bookkeeping entries.
3. F A weekly or semimonthly budget involves far too much bookkeeping.
4. T A budget helps you keep track of allowable deductions and will provide some evidence if the IRS questions those deductions.
5. F See the discussion of fail-safe budgeting (Chapter 4 of the text) for a full explanation of this method.
6. F See the discussion of emotional insights into budgeting and alternative budgeting systems in Chapter 4 of the text.
7. a Inflation affects not only incomes and prices unevenly, but also one's spending patterns and choices

Essay Answers

1. She should use \$2,000 a month, since the bonus has been so erratic, and even zero. If she gets the bonus, she can invest it for additional future budget income or spend it on items not a part of the regular budget. She shouldn't count on the bonus to cover regular expenses, even if it has averaged 50 percent of a month's pay in the past.
2. No. In addition to the geographic differences, there are more important differences due to personal preference, the year in which you bought a home, your level of income, and so on. Instead, you should use your actual personal spending history as a guide to designing your budget.
3. The child-rearing years result in higher food and clothing and recreation expenses, bigger housing requirements, and, possibly, college educations. Fortunately, as shown in text Figure 2-3, these are also typically the parents' highest income years.

1. Forecasting Income (blank form from text Figure 4-1)
2. Forecasting Short-Term Goals (blank form from text Figure 4-3)
3. Forecasting Long-Term Goals (blank form from text Figure 4-4)
4. Forecasting Expenses (blank form from text Figure 4-5)
5. Budget Control Sheet (blank form from text Figure 4-7)

All of these forms are also reproduced in the *Study Guide*.

TRANSPARENCY MASTERS

5 • Insurance Principles

OBJECTIVES After studying this chapter, the students should be able to:

- Explain the purpose of insurance.
- Define and give examples of insurable risks and uninsurable risks.
- Explain which types of risks lend themselves to being prevented from happening, which to being retained, and which to being transferred to an insurance company.
- Use their personal balance sheets and personal income statements to determine their insurance needs.
- Determine whether they have the financial capacity and the loss experience necessary to self-insure.
- Explain how insurance premiums are determined.
- Explain how to buy insurance effectively—what to insure, against what perils, and for how much.
- Explain the role of the insurance agent.
- Describe the parts of an insurance contract.
- List and describe the different types of insurers.

**SUGGESTED
APPROACH**

In this chapter we have presented a general framework for insurance decision making. This framework incorporates careful consideration of the individual's financial strength (as indicated by his or her balance sheet and income statement), ability to avert risk, and personal loss experience. Having considered these factors, your students should be able to compare the various types of insurance available and arrive at financially sound decisions regarding their insurance protection.

We have found it helpful to our students to break down our classroom treatment of the decision-making process into four steps:

1. Emphasize to your students that the very first step is to *determine the maximum potential financial loss*. They must be able to measure the worst that might happen to them so that they can measure the financial importance of a particular risk they are confronting.
2. Point out to your students how to *determine those perils that pose the risks that cause the potential loss*. (At this point you might want to make certain that they can identify insurable as opposed to uninsurable risks.) Help them learn to recognize the probabilities that a peril will occur so that they can measure the likelihood of the risk they are confronting.

3. Once they have learned to recognize and determine the likelihood of perils, you can help them learn to *determine how much of the risk should be prevented, retained, and/or transferred*. They should know how to deal with the risk, given its financial repercussions (step 1) and likelihood (step 2). This requires them to be familiar with the various insurance tactics such as self-insurance and the use of deductibles and insurance policies.
4. Finally, you can discuss how to *implement the insurance decision*. They must know how to select the insurance people and the products necessary to make their insurance tactics work successfully.

Applications

The Chuck and Nancy case study offers enough information that you can apply these four steps to arrive at answers for them. This and other examples you might conjure up would help students see how the concepts work.

An example we have found helpful for class discussion involves the peril of collision damage to one's car. You can apply the above four steps to help decide, for example, whether Marissa should buy collision coverage on her two-year-old car with a market value of \$5,000. The first task is to determine the maximum potential loss. Since you cannot lose more than the car is worth, the maximum potential loss is the car's current market value (i.e., its Blue Book value). Encourage your students to check their autos' Blue Book values at the local library.

Understanding the nature of the peril is the next step. Collision is a fairly easy peril to understand. Since a driver can sue someone else who causes the collision that damages his or her car, the only peril to concern oneself with is the risk of physical damage to one's car caused by a collision that is one's fault. (A proper definition of collision is "coming in contact with another object—another car, an inanimate object, and/or the ground.") The likelihood of this happening to Marissa depends on her loss experience. Since she began driving five years ago, she has incurred \$100 in damages, or an average annual loss of \$20. Based on past experience, the likelihood of a total loss to Marissa's car is relatively low.

Determining how much of the risk should be prevented, retained, or transferred depends on her driving skill, the size of her emergency reserve, and the cost of insurance. She could prevent all of the risk if she didn't drive her car at all. This, of course, is unrealistic. If she had \$5,000 in her savings account, Marissa could afford to retain all the risk. This decision, however, must be viewed in relation to her loss experience and the price of insurance. To test your students' thinking, ask them whether they would encourage Marissa to self-insure if the annual premium an insurance company charges to cover the full risk is \$15, \$20, or \$40. (Assume first that Marissa does have an emergency reserve; then assume that she does not.)

Determining proper implementation of the insurance mechanism depends on whether you decide Marissa should self-insure or buy an insurance policy. Discuss the characteristics an emergency reserve investment should have. You might also discuss the process of shopping for rates and selecting insurance agents and companies that is outlined in the text.

The Four Steps in More Detail

Because our approach may be new to you, we have included the following discussion of each of the four steps listed above. It is designed to explain the steps in more detail and highlight the most important features as well as to provide you with additional background that may prove helpful in answering your students' questions or explaining things they don't fully understand.

Step 1. Determine the maximum potential financial loss. To determine his maximum potential financial loss, a person must first fully understand his current financial position. The balance sheet and income statement he has constructed for himself will tell him the maximum loss he can expect.

If you can get your students to limit their concerns about insurance to the financial ramifications of a potential loss, you will have countered the emotional appeal that characterizes most insurance advertising. Have your students list their financial risks, rank them in order of size, and then use their personal financial statements to determine the loss potential for those risks. (Do not become too concerned about accurate measurement of the financial ramifications of losing one's income stream or assets; this will be covered in great detail in the subsequent insurance chapters. For the purposes of this chapter, a list ranking loss of income, loss of car, loss of home, and so on is sufficient.)

By using financial statements to determine loss potential, students will begin to think in terms of value (dollars and cents) rather than in terms of the loss of various material belongings. At this point you can point out to them that the sole function of insurance policies is to restore value to one's personal finances and not to replace a stolen TV or damaged car.

Step 2. Determine the perils that pose risks of loss. Rather than getting students bogged down in the beginning with a laundry list of perils that might destroy their financial situation, this chapter defines risk and categorizes the various risks in the world today into those that are insurable (that is, that can be transferred to someone else who will assume financial responsibility for them) and those that are not considered insurable (that is, that cannot be transferred). At this point you may want to discuss means of restoring financial worth regardless of how a loss might occur. The main idea to convey at this stage is that one does not profit from insurance, no matter what insurance method one uses.

Step 3. Determine how much of the risk should be prevented, retained, and/or transferred. Once your students know the maximum potential loss that can befall them, they must determine the probability of such a loss actually occurring. Their personal loss experience record will help them determine this probability. The key to determining how much of a loss to assume oneself or to transfer depends on the difference between one's average annual loss experience (in terms of dollars and cents) and the annual premium an insurer would charge. The only time one's personal loss experience should be used to determine whether or not a potential loss *in its entirety* should be retained or transferred is when dealing with a peril one *can control*. For example, just because someone's loss experience on his home may be zero, this does not mean that he has power over the various perils that could endanger it. On the other hand, by careful driving one can avoid causing collision damage to someone's car. Therefore, if one's average annual loss experience is

less than the annual premium for collision coverage, one would be wise to retain the entire risk of loss, provided one has an adequate emergency fund.

By introducing loss experience into the insurance decision we are encouraging students to approach their insurance problems in the way a professional insurer would. However, professional insurers determine loss experiences on groups, or classes, of individuals to arrive at annual premiums, whereas each student should determine, vis-à-vis his own loss experience, whether his average annual expected loss, when compared with the premium an insurer would charge, is greater or smaller than that of the group as a whole. If his average annual expected loss is less, he can consider himself a better risk than the group as a whole and might consider self-insuring.

This can be done easily by following the steps outlined below.

1. Determine the average annual loss.
2. Shop for premiums to determine which insurer offers the best rates for various levels of deductible.
3. Select a deductible whose corresponding premium rate (when added to the loss experience or deductible, whichever is the smaller) is the smallest.
4. Be certain to have an emergency reserve large enough to cover the deductible, should the loss experience take a turn for the worse.

For example, suppose that someone's annual medical bills average \$100. He can buy (1) an insurance policy that will pay all his expenses for \$440 a year; (2) one that pays all but the first \$50, for \$400 a year; (3) one that pays all but the first \$100, for \$360 a year; (4) one that pays all but the first \$200 for \$200 a year; or (5) one that pays all but the first \$500, for \$100 a year. He has \$250 in an emergency reserve. The totals of the premiums plus deductible or loss experience, whichever is smaller, are given in Table 4-A.

TABLE 4-A
COMPARISON OF HEALTH INSURANCE POLICIES

Policy	Annual Premium	Loss Record or Deductible	Total Expected Cost
1 (No deductible)	\$440		\$440
2 (\$ 50 deductible)	400	\$ 50 (deductible)	450
3 (\$100 deductible)	360	100 (deductible)	460
4 (\$200 deductible)	200	100 (loss record)	300
5 (\$500 deductible)	100	100 (loss record)	200

The cheapest policies are the last two, the \$200 and \$500 deductible policies. However, the \$500 deductible poses the possibility of a loss in excess of his ability to absorb it because he has emergency assets of only \$250. Therefore, he would select the \$200 deductible policy and expect to save an average of \$140 a year (\$440 - \$300) over the first-dollar coverage policy. You can see how one's ability to absorb a financial loss oneself (self-insure) can save money on insurance premiums for that part of the loss one does need to transfer.

A final point to emphasize is that normally the risks that are best retained are those with a relatively likely chance of occurring and without the potential for large loss. Those risks best transferred are those that are expected to happen infrequently but carry grave financial consequences if they do.

Step 4. Determine how best to implement the insurance decision. If one decides to self-insure, the implementation problem centers around making sure that one's emergency reserve is large enough to cover the total potential loss and that this reserve is invested in a safe and liquid investment.

If one transfers the risk, the entire process of insurance policy selection is important. One should hire the best people available to handle one's insurance. A premise we believe to be true is that, in the property/casualty area, the agent is all-important, in the life insurance area, the rate is most important.

Since the agent owns one's property and casualty records and can place the business with whomever he or she chooses, that person is the one from whom to expect service. Independent agents can shop among many insurance companies to select the one that offers the best rates and has a good record for paying their claims. In addition, it is in the agent's interest to provide good service: if the company fails to provide adequate backup, the agent will lose the clients' confidence and perhaps their business.

In the property/casualty area, then, one should begin shopping for insurance with selection of the agent. Larger agencies draw the larger companies wanting the greatest market exposure, so the most competitive quotes might be expected to come from them. Once a couple of agents have been screened, shop for rates. However, one is not as likely to find as much disparity in rates among property/casualty insurers as among life insurance companies. (In the *Study Guide* we have supplied a copy of an HO-3 policy for the student's perusal.)

Agents are less important on the life insurance side because the companies make all the underwriting decisions. Because of the stiff reserve requirements applied to the life insurance industry, life insurance companies tend to be financially stronger than their property/casualty counterparts. They are also more profitable. Since different life insurance companies will stress different types of policies, be certain to shop for rates—there are huge disparities from one company to another. The best way to give students a feeling for this is to have them call various life insurance agents for rate quotes for some hypothetical situations. If you get one lesson across to your students concerning insurance companies and agencies, let it be that they are not all alike in the products they offer, the way they sell them, or the prices they charge.

In addition to explaining how insurance companies and agents fit into the insurance framework, emphasize that the students' approach to insurance, no matter what type, should always be the same: know what they want to insure, what to insure it against, how much to insure it for, how long to insure it, and where to buy the insurance. If they know these five things, they can solve their insurance needs.

GUEST LECTURE IDEAS

1. Bring an insurance agent into the class who is familiar with both life/health and property/casualty insurance. Ask him or her to talk to the class about the following areas:
 - a. Insurance rate-making (setting premiums). How it is done and how it differs from one coverage area to another (such as life versus auto).

- b. Areas of risk that are considered insurable today that weren't considered insurable a few years ago; plus a look at what risks might in the future be considered insurable.
 - c. Things to look for in selecting a good insurance agent.
 - d. The reason for deductibles, from the insurance industry's point of view, and opportunities for saving premium dollars through using deductibles.
- 2. If possible, invite a representative from the state Department of Insurance to talk to the class about the following topics:
 - a. What the Department of Insurance does.
 - b. Methods for enforcing its regulations and pursuing policyholder complaints.
 - c. The future of national regulation versus continued state regulation of insurance.

- 1. Contact your state Department of Insurance and request information (such as financial statement and complaint records) on three different insurance companies of your choice. Then have your students analyze the information provided and compare the three. Have them state which company they would feel most comfortable with and why. Have the members of your class compare their findings.
- 2. Have your students call insurance agents for rate quotes. First they should look in the yellow pages of the local telephone directory and select three large agencies. Then they should call for quotes on their present auto insurance coverage and ask each agent to submit his "best quote" for their comparison. Have them compare the quotes they receive first with what they are presently paying for coverage and then with those of others in their class.
- 3. Have your students visit the library and look at *Best's Insurance Rating Guide*, *Fitchcraft*, and other insurance compendiums. Compare financial ratings and premium rates between one insurance company and another.

ADDITIONAL MATERIALS AND ACTIVITIES

- 1. Investment risks offer the opportunity for gain as well as loss. Insurable risks offer only the opportunity for loss.
- 2. The three ways insurable risks can be treated are:
 - Prevent or minimize them through cautious action.
 - Retain them, agreeing to absorb the potential financial loss yourself.
 - Transfer them to an insurance company.

ANSWERS TO CHAPTER QUESTIONS

All three approaches could be used in the following ways to deal with the risk of fire damage to personal property.

- Prevention: Be sure electrical wiring is adequate and in good condition; keep a fire extinguisher in a convenient location. (These are only examples of methods of prevention. Your students may have

other equally acceptable suggestions. It is the idea of prevention that is important here.)

- Retention: Take a deductible on the policy you buy to insure against fire damage.
- Transfer: Pass the entire burden, less the deductible you have chosen, on to the insurance company.

3. I would want to self-insure if I anticipate that my driving experience will not worsen, because my average annual loss due to collision is less than the annual premium an insurance company charges.

The average loss per year due to collision over the five years is \$80 ($\$400 \div 5$). If the driving experience won't get worse, over the long run, I would be better off by an average of \$20 a year (\$100 premium, \$80 average annual loss) if I were to self-insure.

I would not want to self-insure if I could obtain insurance coverage that would cost me at least \$20 a year less than my present coverage does.

4. I would buy the new policy at \$35 a month with a \$100 deductible because that way I can save at least \$13.33 a month over my current policy. If my loss experience remains the same, the most I would ever have to pay would be an average of \$41.67 ($\$80$ average expense per year $\div 12$ months + \$35 monthly premium), whereas with my current insurance I pay \$55 a month.

It would be incorrect to say that, since my average monthly cost is less than the cost of either policy, I should self-insure. The potential cost of serious illness makes it imperative that everyone carry health insurance even if he can afford the self-insurance necessitated by a very high deductible.

5. I might reasonably retain the following risks:

- My bicycle might be stolen.
This is a fairly likely occurrence (which causes premiums to be high) and involves an item of relatively low value.
- I might die leaving no dependents.
I don't need life insurance because there is no one for whom I have to provide after my death.
- I might need a penicillin shot.
The cost of the shot would be less than the cost of transferring the risk.

I might reasonably transfer:

- My home might burn down.
There is little likelihood that this will occur; therefore, premiums are low in relation to the value covered. Also, it would be difficult to replace a home without considerable financial help.
- I might have a heart attack and need to be hospitalized.
Both the frequency and cost of this risk are impossible to anticipate and therefore should be transferred.
- A tree might fall on my car, crushing it.
Unless I live where there are no trees, the risk of having a tree fall on my car would be impossible to anticipate and the cost of the

damage could be high unless my car happened to be very old. Therefore, the cost of the premium would, in most cases, be very low compared to the possible financial loss.

- I might die leaving a spouse and three children.

I am young, death is unlikely, and the financial ramifications of my death would be large. Therefore, the cost of insurance would be low in relation to the possible financial disaster my dependents would face if I were to die. If I were older, my children were self-supporting, and I had accumulated enough assets so that my spouse would be comfortably provided for, I would retain the risk.

6. The base premium would be \$20.

$$\frac{\$50,000 \text{ in losses}}{2,500 \text{ loss exposures}} = \$20$$

Student-Oriented Case Problem

The Phillipses' greatest financial risk is the loss of their home (\$35,000); their second greatest risk is the loss of their personal property (\$15,000); and the third is the loss of their automobile (\$500).

All of these risks can be transferred to an insurance company. The risk of loss to their personal property should be transferred in its entirety because the annual premium outlay for full coverage is less than the average annual loss.

If the Phillipses can expect their driving records not to become worse, all of the auto risk should be retained because their average annual loss is less than the annual premium and they have sufficient assets so that if the car were totally destroyed they could replace it with \$1,500 worth of monetary assets.

Since they would not have sufficient assets to cover the potential loss without insurance, it makes sense for them to insure their home for its full value. They should use a deductible because their current loss experience indicates that, on the average, they would have to pay only \$50 every year. Since the Phillipses have an emergency reserve of \$4,360, they can probably afford a \$500 deductible, or an expected annual outlay of \$151 (\$101 premium + \$50 average annual loss experience)—a saving of \$29 over the \$180 they are currently paying. However, raising the deductible to \$1,000 just to save another \$13 in the annual premium does not seem to be warranted.

The total amount in premiums that our insurance recommendations would save the Phillipses each year is \$84—\$55 saved on the car (\$85 premium dropped and \$30 assumed as average loss experience) plus \$29 saved on the house.

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

Chuck and Nancy Anderson Computing the Size of Their Emergency Fund

1. An appropriate amount for their emergency fund is \$4,300.

The emergency fund should be roughly two to three times the amount of the Andersons' \$2,163 total monthly take-home pay $((\$21,000 + 12,000 - 7,040) \div 12)$. In Chuck and Nancy's case, because they have financial assets upon which they can draw, twice the amount of their take-home pay should be adequate.

2. On the Andersons' income statement and balance sheet the amount of their savings account will be increased by \$1,600.

Objective Questions

SAMPLE TEST QUESTIONS

Circle the letter of the correct answer to each question.

1. The purpose of insurance is to
 - a. enable you to profit if something you own is lost or destroyed
 - b. express your love and concern for the safety of a loved one
 - c. restore your financial situation to the position existing prior to a loss
 - d. (None of the above)
2. The risk of flunking a final exam is an insurable risk.

True False
3. The risk of a nuclear holocaust is an insurable risk.

True False
4. The risk of losing money on a real estate investment is an insurable risk.

True False
5. Which of the following risks might best be retained?
 - a. The risk of fire damage to your home
 - b. The risk of an annual doctor's checkup
 - c. The risk of being sued for accidentally pushing someone down the stairs
 - d. (All of the above)
6. Which of the following must be true before you should self-insure?
 - a. You should be financially able to absorb the potential loss.
 - b. Your average annual loss experience is less than the annual premium an insurance company would charge to cover the risk.
 - c. You have reason to believe that your loss experiences will not worsen.
 - d. (All of the above)
7. An insurance company is making an "underwriting profit" if they are attracting more good risks than bad, are performing their job efficiently, and/or are charging too high a premium.

True False
8. Deductibles are the way to
 - a. reduce insurance costs
 - b. minimize your risk of loss
 - c. increase the agent's commission
 - d. (None of the above)
9. Property/casualty agents differ from health/life agents in that they have the power to bind you.

True False

Essay Questions

1. Although all of us live differently, we many times encounter the same risks. Think of your life in terms of the risks you are exposed to each day and circle those risks on your list that are insurable. Next, for each circled risk, determine whether you should prevent, retain, or transfer it and place a "P," "R," or "T" beside it to indicate your decision. How many risks fall into each of the three categories? What percentage of the risks are transferable? Which type of insurance policy (property, liability, health, or life) is available to cover those risks?
2. Discuss the critical differences between property/casualty and life/health agents, and explain the importance of both in the insurance buying decision.

Objective Answers

ANSWERS TO SAMPLE TEST QUESTIONS

1. c The purpose of insurance is to restore financial value that may be lost because of a calamity caused by an insurable peril. You do not make a profit on insurance. Insurance is a financial decision, not an emotional one.
2. F This is not an insurable risk—there would be no direct financial repercussions from failing an exam; also, failing may not be a fortuitous risk (due to the temptation that you might receive money if you failed intentionally).
3. F Since a nuclear holocaust is not personal in origin and because it would involve too great a financial loss, insurance companies will not insure against its occurrence.
4. F Because investing in real estate involves the chance for gain as well as loss, it is not an insurable risk.
5. b An annual doctor's checkup is a high frequency risk with small financial loss consequences. The costs of carrying and administering such coverage make the annual premium almost as much as the total possible benefit.
6. d All of these criteria must be met before self-insurance can be justified.
7. T An underwriting profit occurs whenever an insurer charges more for insurance coverage than he pays out in claims. Any, or all of the three, conditions mentioned in the question could allow the company to show a profit.
8. a Deductibles are a way of reducing the premium outlay for insurance coverage. They expose the insured to a greater portion of the total risk, thereby saving the insurance company money that would have to be paid out in claims. Deductibles actually increase your potential loss. Because deductibles reduce premiums, they reduce the amount of the insurance agent's commission—commissions are a percentage of premiums charged.
9. T Property/casualty agents own your records, do the underwriting themselves, and therefore, can tell you if you are covered or not prior to a formal contract being issued by the insurer. A binder agreement assures you that your prospective insurance company will pay any losses that occur before the actual policy is issued. Health/life agents, on the other hand, are only sales representatives for their companies. They do not have the power to decide whether or not you can be granted insurance coverage.

Essay Answers

1. Students should list a host of risks that run the gamut between temptations and reality. Judge the appropriateness of the risks prevented, retained, and transferred, given the average financial status of your students. Finally, see whether the student has accurately classified the risks to be transferred with the correct policy type.

2. Agent differences:

- a. Property/casualty agent performs some of the underwriting function, while life/health agents sell only.
- b. Property/casualty agents have the power to bind an insurance company, while life/health agents can only submit applications to the insurance company, who then must accept the risk or not.

Importance in insurance decisions:

- a. Agents are always important but the need for claim serving arises more frequently in property/casualty situations; hence, they are more important here than a life/health agent.
- b. Rate disparity is greater in life/health than property/casualty; therefore, rates are more important than the agent in life/health decisions.

6 • Property Insurance

After studying this chapter, the students should be able to:

OBJECTIVES

- Explain what kinds of property they can and should insure.
- Make an inventory of their personal property and explain the uses of such an inventory.
- Explain how to compute market value and replacement value and why the latter is generally preferable for insuring both personal and real property.
- Explain how the coinsurance principle works and why it is important.
- Describe the various kinds of policies offered and choose those best suited to their needs.
- Describe how certain limiting clauses in policies can affect the insured's protection.
- Explain how premiums are determined and the various ways a person can lower the cost of property insurance.

The most important concept for you to help your students grasp as a result of reading this chapter is how to apply methods whereby they can determine insurable values for their homes and personal property. They should use replacement cost for their home and, when possible, their personal property. The market value only applies to personal property when the replacement cost alternative is not available.

SUGGESTED APPROACH

Replacement cost is the easier of the two to determine. By calling either the local real estate board or several local contractors, you and your students can find a per-square-foot cost that can readily be agreed upon by builders. A good exercise for your class would be to find replacement cost measurements for various surrounding communities. This will demonstrate how costs can differ depending on the quality and size of home from one community to another even though they may be geographically close. Naturally, you can expect custom homes to cost more to replace than standard tract homes. Once your students understand how coinsurance works, they will understand why determining an accurate replacement cost figure is important. (If they violate the coinsurance requirements, they end up paying for coverage they could never receive.)

Market value tends to be a rather subjective type of measurement. To offset this tendency, we have selected for use in our text a method of determining the market value of personal property that uses annual depreciation

percentages for the different types of personal property. The appropriate percentage is multiplied by the article's replacement cost, and the result is deducted from that cost. Thus this method considers not only that property may depreciate in value due to normal wear but also that general inflation may cause people to pay more for things today simply because the purchasing power of the dollar may have decreased. For these reasons, we feel that the method for determining market value espoused in this chapter offers a relatively accurate figure the student can use when computing the market value of personal property.

Stress to your students the importance of taking pictures of their personal property. Pictures can show an insurance appraiser that their belongings may have more value than the depreciation schedules would assign. Pictures also indicate the position of furniture in the home. Along with a personal property inventory, pictures can document both the quantity and the quality of the property lost or destroyed.

The second very important point, and one we suggest you emphasize in class, is that, by knowing the maximum loss exposures before a calamity strikes, the insured and the insurance agent can reach a realistic agreement on how much of the exposure the company will carry and how much the insured will retain. By creating a personal property inventory (even though this takes a lot of time) and filing a copy of it with the insurance agent, the insured will know just what to expect of his or her insurance and need not be surprised or disappointed over a claims settlement.

In this chapter, there are two questions of choice over which the instructor should exercise some influence. The first is the question of insuring one's personal property for its replacement cost as opposed to its market value. Few people would want to hunt through used furniture stores to buy furniture identical in age and condition to what they lost through fire, for example. We advise our students and clients to choose, whenever possible, an insurance policy that insures the personal property for its replacement cost. The total amount of insurance required under the replacement cost endorsement can be found by summing the totals in column 7 of the student's personal property inventory (illustrated in Figure 6-1 in the text and reproduced as a blank form in the *Study Guide* as well as at the end of this guide).

The second question is that of whether to insure all of one's personal property or only those items one is concerned about losing. The instructor should emphasize that, since most people would rather replace lost articles with brand new ones, the only way to have enough money for what they want to replace is to take some of the money paid to reimburse them for the loss of an item they no longer care about and add it to the money they can spend on those items they especially want to replace. In this way, one might not have to buy a 10-year-old refrigerator to take the place of a 10-year-old refrigerator that was destroyed.

The only insurance policies you should spend much time discussing in class are the homeowners policies and the floater policies. These policies will be the ones that, nine times out of ten, will be required by the student and recommended by the agent. By using Table 6-3 in the text, you should be able to highlight the advantages of one policy over another. It is not so important that the students know all the various alternative policies in detail, but rather that they be able to recognize, given their needs, which one or two stand the best chance of fulfilling those needs. Table 6-3 in the text

should answer that question for them. Then they can return to the section of the text that discusses those one or two policies to learn the minute differences between them.

Encourage your students to shop for comparable policies using the shopping for property insurance form (Figure 6-2 in the text). It is reproduced also in the *Study Guide* and (for use as a transparency master) at the end of this guide.

SAMPLE CASES

1. When Joe's agent suggested that Joe take pictures of his furniture in order to help substantiate a potential claim, Joe got a bright idea. He took his camera down to the furniture store and took 60 pictures of showroom model sofas, stuffed chairs, dining room sets, beds, appliances, and so on. After getting the pictures developed, Joe put them in an envelope and put the envelope in his safe-deposit box. Sure enough, the potentiality that Joe's agent had warned against became a reality one day when Joe's home burned to the ground. Joe was distraught. However, he felt thankful, if not deceitful, when he remembered the pictures in his safe-deposit box. The next day, Joe and his agent met with his insurance company's claims adjuster and Joe brought out his pictures. As the adjuster looked through the pictures, his smile turned to a frown. "How come you have so many sofas?" the adjuster asked. "We have a big living room and . . . we entertain a lot!" Joe replied, feeling uneasy but pleased with his fast thinking. "How come you left the price tags on this dinette set?" the adjuster asked. Turning a deep red, Joe replied, "We're a trifle ostentatious and like to brag a lot."

Moral: Don't try to fool claims adjusters unless you're an awfully good liar or don't mind going to jail.

2. Bill did not understand why he should spend so much money on a property insurance policy when all he was basically concerned about was fire. So he purchased the cheapest homeowners policy he could: a HO-1 policy. One evening Bill and his wife, Betty, returned home after playing bridge with Pete and Julie to find a huge hole in their living room wall. Unlocking their front door, they found that someone had cleaned them out of all of their furniture, apparently having used a bulldozer to create an opening large enough to quickly remove even the largest items. Bill ran upstairs to get his homeowners policy and phoned his insurance agent. His agent assured him that all damage would be repaired according to the conditions of his policy. The next day, bright and early, a sheet rocker, carpenter, and mason arrived and quickly repaired the hole in Bill's living room wall. Bill and Betty were very pleased with their work and with how quickly the agent had responded to their need. However, the next week no claims adjuster came to settle on the value of all their furniture. Bill was getting annoyed sleeping on the floor and cooking in the fireplace, and so at last he called his agent. "Has the hole been satisfactorily repaired?" began the agent. "Yes, yes," said Bill, getting more angry, "but what about my furniture? Everything we own has been stolen now for two weeks." A long silence followed. At last, his agent said, "But, Bill, you said you wanted the least expensive policy. Your

HO-1 only covers you for damage done by a thief, not for what a thief steals."

Moral: Don't second guess what perils might befall you. Cover your home against *all* risks.

GUEST LECTURE IDEAS

1. Invite an independent insurance appraiser to discuss before your class the various ways he goes about trying to construct the value of personal property existing in a home prior to a loss.

This should reinforce in the minds of your students the need for a personal property inventory.

2. Invite a member of the local fire department and/or a member of the local police department to talk to your class about how they might prevent a peril from occurring. (Past syndicated articles written by reformed burglars point out some interesting precautions one might take to make a home burglarproof.) In addition, they might talk in general about the loss experience in your local community.
3. Invite a property insurance agent to discuss the types of homeowners policies available and under what circumstances they should be used. Also, have him discuss floater policies for various types of high-value items and how they interface with homeowners policies.

ADDITIONAL MATERIALS AND ACTIVITIES

1. Have each student prepare his or her own personal property inventory. Note the disparity between the property's replacement cost and fair market value. Encourage your students to take pictures. (The forms are provided in the *Study Guide*.)
2. If possible, visit the claims division of an insurance company in your area, and see how claims are processed. Note the roles of the various people in this process: the agent, claims adjuster, insurance company representative, police and/or fire department.
3. Instruct all your students to obtain three different rate quotes on a sample insurance situation (2,200 square-foot frame home, in a certain part of town, HO-3 policy, \$250 deductible), and divide up the independent agencies and direct representatives among your students. Compile the information to determine the highest, cheapest, and average rate quotes.

ANSWERS TO CHAPTER QUESTIONS

1. No, I can't insure my neighbor's home unless I own it and he rents it from me. If he owns it, I will not incur a financial loss if it is damaged or destroyed; therefore, I have no insurable financial interest in it.
2. The fire policy would pay two-thirds of the loss (the proportion that the \$40,000 fire policy is to the total coverage of \$60,000) or \$26,800 and the homeowners policy would pay one-third or \$13,200.

3. I should prepare a personal property inventory because:

- It will tell me how much my personal property is worth for insurance purposes, whether I insure it for replacement cost or market value.
- It will reinforce claims to my insurance company because it will document the existence and value of any item that might be lost or damaged.
- It will tell me where items of value are located in my home (this will enable me to know exactly what has been lost or destroyed in any given area of the house).
- It will enable me to distribute value evenly throughout the house, thereby reducing the possibility of an unduly large loss in any one area of the house.

4. The market value of a four-year-old sofa, costing \$800 new today, is \$480.

$$\begin{aligned}4 \text{ years} \times 10\% \text{ annual depreciation} &= 40\% \\40\% \times \$800 &= \$320 \\\$800 - \$320 &= \$480\end{aligned}$$

The market value of a two-year-old wooden dinette set, costing \$300 new today, is \$258.

The market value of a three-year-old TV, costing \$400 new today, is \$280.

5. The best way to account for inflation when insuring my home is to insure it for its current replacement cost, recompute the replacement value each year, and adjust the policy limits accordingly.
6. The insurance companies would have to charge each homeowner a base premium of \$40.

$$\$200,000 \text{ expected fire loss} \div 5,000 \text{ homeowners} = \$40$$

7. Harry's insurance company would pay \$6,250.

According to the coinsurance clause, he should have been insured for \$48,000 (80% of the \$60,000 replacement cost of his house). By insuring for only \$30,000, Larry is entitled to receive only \$6,250—five-eighths of the \$10,000 loss—because he held only five-eighths of the amount of insurance the coinsurance clause required him to carry on property with a \$60,000 replacement cost.

8. Homeowners form 3 offers the broadest coverage at the least cost. It offers the most coverage against perils endangering the home (i.e., all-risk coverage) yet eliminates moral hazard and the attendant higher cost by covering personal property only against damage from certain specified perils.
9. Homeowners form 4 policies would be best suited because they offer both broad peril coverage and liability coverage on unscheduled property in one policy.
10. Floater policies protect the covered property for the same limits anywhere in the world whereas homeowners policies protect your personal

property when not on the covered premises only up to 5 percent of the insured value of the home. They protect personal property up to 10 percent of the coverage on the property while on the covered premises. Also, floater policies offer higher limits on high-value items.

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

Student-Oriented Case Problems

1. The size of the Lewises' risk exposure is \$1,275—the sum total of all the market values of their personal belongings. All of the potential loss could be covered by insurance. Since Jim and Janet rent an apartment, a homeowners form 4 for \$1,300 would be appropriate. If they have sufficient monetary assets and a good loss experience, however, they need not insure their belongings at all because the total potential loss is so small.
2. The Lees should carry \$44,000 worth of insurance coverage (110% × \$40,000 original cost) on their home, an amount equal to the home's full replacement cost. The minimum amount of insurance they should carry is \$35,200 (\$44,000 replacement cost × 80% coinsurance requirement). Their existing coverage would pay only \$8,523 if they were to incur a \$10,000 loss today

$$\frac{\$30,000 \text{ insurance in force}}{\$35,200 \text{ coinsurance requirement}} \times \$10,000 \text{ loss} = \$8,523$$

Chuck and Nancy Anderson Insuring Their Home against Financial Calamity

1. The Andersons have too little fire damage protection, much too little protection against damage caused by anything other than fire, and less than one-third the amount of insurance they should carry on their personal property.
2. I would recommend a homeowners form 3 policy with limits of \$50,000 on their home and \$25,000 on their personal property. This policy will cost \$280.

The dwelling building(s) and contents form doesn't provide theft coverage or all-risk coverage on the home. Homeowners form 5 offers a little more coverage on personal property but not enough to make it worthwhile to pay twice as much as they would pay for an HO-3.

3. The Andersons' property insurance expense on their income statement will increase by \$198.

Objective Questions

SAMPLE TEST QUESTIONS

Circle the letter of the correct answer to each question.

1. All of the following types of property can be insured against damage or loss except
 - a. house
 - b. tool shed
 - c. land
 - d. furniture
2. You can insure your personal property for its replacement cost.

True False
3. The difference between market value and replacement cost is that market value takes depreciation into account while replacement cost does not.

True False
4. If a home with a replacement cost of \$50,000 is insured for \$20,000, how much will the insurance policy pay on a \$10,000 claim?
 - a. \$10,000
 - b. \$8,000
 - c. \$5,000
 - d. 0
5. Which of the following policies covers the damage done by a burglar but not the property stolen?
 - a. Basic fire policy
 - b. Dwelling building(s) special form
 - c. Dwelling building(s) and contents form
 - d. Homeowners form 4
6. What is the minimum coverage permitted by a homeowners form 3 policy?
 - a. \$10,000
 - b. \$8,000
 - c. \$5,000
 - d. No minimum
7. A personal property floater is more expensive than a personal articles floater because the covered property is not scheduled.

True False
8. Assuming you have two similar policies—one for \$10,000 and the other for \$30,000—covering a \$40,000 home, how much would the \$10,000 policy pay on a \$20,000 claim?
 - a. \$10,000
 - b. \$5,000
 - c. \$2,500
 - d. 0

9. You can lower the cost of property insurance by
- a. increasing the deductible
 - b. purchasing package policies rather than separate peril policies
 - c. living in an area where theft activity is low
 - d. (All of the above)
10. The coinsurance clause comes into effect only when both the amount of the insurance and the amount of the loss fall below 80 percent of the replacement value.
- True False
11. The standard deductible on earthquake policies is
- a. 5%
 - b. 10%
 - c. \$250
 - d. (None of the above)

Essay Questions

1. If you wanted to protect your home and personal property from theft, what policy(s) would you buy and why?
2. What does the inflation guard policy do, and how well does it do it?
3. What is the homeowners replacement cost and inflation protection endorsement, and how well does it do its job?

Objective Answers

ANSWERS TO SAMPLE TEST QUESTIONS

1. c Land cannot be insured because the insurance industry considers it indestructible.
2. T To do so, you must purchase the correct endorsement. Personal property can also be insured for its market value.
3. T Market value assumes changes in redeemable value due to normal use of the property. Replacement cost reimburses you for what it would cost to replace an item with a new one.
4. c According to coinsurance, in order to recoup the total loss you would have to be insured for at least 80 percent of the replacement cost of the house. If you are insured for less than 80 percent, you are reimbursed according to the ratio of the amount representing the percentage of coverage you carried to the amount representing the percentage of coverage you should have carried.
Therefore, because your property was worth \$50,000, you should have been insured for 80 percent (4/5) of \$50,000 (or \$40,000). You were insured for \$20,000—one-half of the minimum for which you should have been insured. As a result, your insurance would pay you one-half of the amount of the claim.
5. c A dwelling building(s) and contents form covers only the damage done by the burglar while burglarizing your home.
6. b \$8,000 is the minimum allowable coverage on all homeowner forms 1, 2, and 3. The minimum coverage on an HO-5 policy, however, is \$15,000.
7. T A policy that defines the articles actually covered by insurance is cheaper than one that does not because it limits the insurance company's risk exposure.
8. b Due to the other-insurance clause, an insurance policy will pay only that portion of the loss bearing the same relationship to the total applicable coverage on the property as its policy's limits do.
9. d
10. T
11. a

Essay Answers

1. Buy an HO-3 because you want to be covered for more than theft, with a personal articles floater for high-value items where their aggregate value exceeds the HO-3 \$500 limit. In addition, purchase an extended theft endorsement to cover your property while in an automobile or watercraft. The extended theft coverage pays, whether or not there are signs of forcible entry and whether or not all doors and windows were locked.
2. Inflation guard policies automatically adjust policy limits upward approximately 8 to 10 percent a year supposedly to keep pace with infla-

tion. Unfortunately, construction costs may rise faster than this. So it is best to check local construction costs on a per-square-foot basis at each renewal time and set your own limits to guard against increased replacement costs caused by inflation.

3. Under this endorsement, the insurance company can raise or lower your limits based on their estimate of your home's replacement cost. If they make an error, and the limits are below 80 percent of your home's actual replacement cost, then coinsurance doesn't apply; the company will pay 100 percent of the loss up to the policy's limits. The problem arises in a total loss if the limits set by the company are not sufficient to replace the dwelling. In this case, the insurance company would not be on the hook. Therefore, once again, the burden of accurately determining your home's replacement cost lies with you and your agent.

TRANSPARENCY MASTERS

1. Personal Property Inventory (blank form from text Figure 6-1)
2. Shopping for Property Insurance (text Figure 6-2)
3. Sample HO-3 policy
4. Sample HO-4 policy
5. Sample floater policy

The first three of these are also reproduced in the *Study Guide*, although the HO-3 policy is presented in Chapter 5 there.

7 • Comprehensive Liability and Auto Insurance

After studying this chapter, the students should be able to:

OBJECTIVES

- Define negligence, absolute liability, and vicarious liability.
- Describe the three legal defenses possible in a liability suit, including the doctrine of comparative negligence.
- Decide how much liability insurance coverage they need, taking into consideration their liability exposure and their financial position.
- Describe the types of comprehensive liability insurance available and their provisions.
- Describe the types of automobile insurance available and their provisions.
- Choose appropriate auto coverages for them at the lowest costs.
- Explain what to do and not do if involved in an automobile accident.

To our minds, the four most important topics in this chapter are (1) determining liability exposure, (2) self-insuring collision risks, (3) rate making, and (4) claims settlement. Our treatment of these areas of liability insurance is a great deal more detailed than that offered by more conventional texts on personal finance. In the first three topics, we express a point of view and try to establish some rules for making decisions in what, admittedly, are fairly hazy areas of liability insurance. If you present your point of view either as agreeing or disagreeing with our own (and offer your reasons why in either case), the whole area of liability insurance selection can become more meaningful to the students.

SUGGESTED APPROACH

Your students should be more involved in the liability insurance question than any other because their largest insurance outlay will likely be their auto insurance premiums. Therefore, we feel this subject deserves the detailed treatment we have given it. Our points of view on the four major topics are expressed below.

1. *Determining your liability exposure.* The extent of one's liability exposure depends, in large part, on unknown factors—the motivations and personality of the other party. A liability situation offers an opportunity for extreme differences in reaction and behavior, for both the positive and the negative sides of human nature to display themselves. This possibility must be taken into account when selecting insurance.

The maximum potential loss due to liability exposure is very difficult to define. In our text we provide a method for arriving at a liability insurance limit based on external factors, rather than strictly internal ones. An internal approach is to say "no one can sue me for more than I have," and thus to insure for one's net worth. But what is to stop a person from suing you for all of your insurance, plus your net worth? We suggest you stress to your students that the setting of liability limits must be tempered with the external realities: how juries react, the financial advantages to claimants in getting what they can now instead of promises for the future, and so on. Point out to them that people pass through various phases of liability exposure—phases that change more because others perceive a person differently depending upon their financial visibility than because of their actual financial worth. The limits we prescribe in the text are safe limits based on our consulting experience, the American system of jurisprudence, and a consideration of the vast differences in the personalities of people. You will notice that we consider higher auto insurance liability limits to be more necessary than higher comprehensive liability limits. Once again, this is because of the external factors in the case of auto insurance claims: compared to comprehensive liability claims, the chances are greater that one will be dealing with strangers, that more than one individual will be involved, and so on.

2. *Self-insuring collision risks.* The most likely area for self-insurance as a viable alternative to buying insurance is collision coverage. We have found it worthwhile to stress in class the three reasons why collision damage lends itself to self-insurance:

- Collision insurance pays only if the insured driver is at fault; therefore, the risk of collision is a risk that the driver can control by driving safely. The only exceptions to the fault condition would be if your car were damaged by an uninsured motorist (and in that case uninsured motorist insurance will not pay for damage to the car) or by a hit-and-run driver who is never apprehended.
- A car owner's maximum potential loss is limited to the current market value of the car (a value that declines each year by rather sizable amounts of money) and therefore represents a measurable dollar risk that is usually relatively small (particularly in light of the fact that all but the first \$100 of any physical damage loss is deductible for income tax purposes.)
- Collision insurance premiums do not decrease as fast as the value of the car.

The only way a student can determine whether self-insurance in this area is financially sensible for him or her is to embark upon an analysis such as Bill ran through in Chapter 7 in the text. Students who have old cars, have a cash reserve sufficient to buy similar old cars, and are good drivers should probably decide (as a result of what they learn both in class and from the text) to eliminate collision coverage. Students who are good drivers but have new high-value cars will probably want to buy insurance, although those with cash reserves may do well to take a high deductible. Students who are poor risks should buy collision coverage with the highest deductible their emergency assets can afford, thereby reducing their premiums as much as they can.

3. *Rate making.* Investigate the point system in your state so that you can explain how rates are affected by one's driving record. The point system presented in the book is for the state of California. Also check with your local insurance agents or the insurance commissioner's office to see how prevalent the following rate discounts are: compact car discount, old age discount, good student discount, and nondrinker discount. These discounts vary by locality and by company policy. Since we cannot speak specifically for every state or community, some research of your own is going to be required. If you can do that research, this aspect of the chapter will be more relevant to your students' particular situation.

Also encourage your students to shop for rates using the shopping for auto insurance form (text Figure 7-1). It is reproduced in the *Study Guide* and (for use as a transparency master) at the end of this guide.

4. *Claims settlement.* Based on conversations with both claims adjusters and claimants, we have tried to re-create as accurately as we can the claims settlement procedure, particularly where medical treatment is involved. The insurance industry will probably not approve of our re-creation. However, we feel strongly that insurance adjusters so frequently try to take advantage of unwary claimants that caution and a reasonable degree of suspicion are entirely warranted. Here, calling for personal experiences of class members or people they know will add greatly to your class discussion about claims settlement. Having a claims adjuster and an attorney address your class, or even debate before your class, will also prove enlightening. Emphasize strongly the material on what to do if an accident is the other guy's fault. Your students may well end up needing this knowledge just as much as they need their insurance policy.

1. Larry was invited to lunch by his father's auto insurance agent when Larry's dad gave him a car between his freshman and sophomore year in college. The agent cordially outlined the auto policy that would now be his, describing the coverage areas in great detail and offering his continued help in processing any claims that might arise. As lunch was drawing to a close, the agent, almost as an afterthought, asked Larry: "By the way, son, have you had any moving traffic violations or accidents in the last three years?" At that, Larry sat back in his chair, his eyes focused on the ceiling as if deep in thought, and recounted slowly, "Well, there was that ticket in Nebraska two years ago, then that one in New Mexico—that was a jip—and two in San Francisco last May, and. . . ." The agent turned a deep red and gently reached for the policy that Larry had clutched in his hands. Leaning forward, the agent looked at Larry and said, "My insurance company cannot write coverage on anyone who has compiled so many tickets. In fact, you may be uninsurable." However, being a smart agent, he sat back and thought a minute. Then he said, "You know, your driver's license is issued in Illinois. Have you ever had a ticket in Illinois?" "No," Larry replied. "Then you write the Department of Motor Vehicles in Illinois and request a readout on your driving record. It just may be that the other states didn't record your mishaps with the Illinois DMV."
- SAMPLE CASES

Well, that agent's advice was as good as gold, for within 10 days Larry received a letter back from the Illinois DMV congratulating him on his clean driving record. And, of course, the wise old agent was able to write that policy he'd described at length to Larry over lunch.

Moral: Don't guess about your driving record; check with your state's DMV.

2. Greg had compiled a miserable driving record ever since he'd received his driver's license four years ago. In fact, his father's auto insurance agent advised his father that if Greg received just one more moving traffic violation, Greg would lose his coverage and be put on an assigned risk plan. Now Greg's car was covered on his father's policy and was just one of three cars in the family: his father's Mercedes 450SLC, his mother's Ford LTD station wagon, and Greg's Toyota Celica GT. His father's agent pointed out that, since Greg lived at home, Greg's insurance rating, loaded with penalty increases totaling three times his normal premium, was being applied to the most expensive car—his father's Mercedes. Thus the annual premium was extremely high, because the worst driver rating was being applied to the car with the highest premium, anyway. The agent wisely advised his father to split Greg off from the family policy and issue one on Greg and his car separately. It was a wise move because the increase in premium on the Celica due to Greg's being named as a principal operator plus the loss of the multiple car discount was still less than the decrease in his father's premium resulting from removing Greg from the policy.

Moral: If you are a member of a family in which one of you has a terrible driving record, it may be cheaper to split off that "terrible" driver on his own policy rather than to continue to carry him on your family multiple car policy.

GUEST LECTURE IDEAS

1. Schedule a debate between an insurance claims adjuster and a personal liability attorney. This should help your students understand the differences in their sometimes quite contrary points of view. (The attorney will be out to protect the rights of the individual and increase the amount of the claim as much as possible, and the adjuster will be concerned with minimizing the insurance company's outlay.)
2. Invite a representative from your state's Department of Motor Vehicles or Highway Safety to talk to the class about what can be done to reduce the number of accidents that occur, keep drunk drivers off the road, and so forth.
3. Invite a representative of your state's Highway Patrol to talk to the class about how and when to report an accident. You might follow up with a discussion of the insurance consequences of reporting or failing to report an accident.

ADDITIONAL MATERIALS AND ACTIVITIES

1. Schedule a class debate between those members of the class who advocate no-fault insurance and those who oppose it. Have both sides research the issue from their respective points of view.

2. Have one or two students research the point system in your state and report to the class on (1) how points are assigned, (2) how long points stay on someone's driving record, and (3) how many points result in rate increases and the amounts of those increases.
3. Have your students call three agents each to acquire premium quotes on a uniform sample insurance situation. Compare the quotes to see the dollar and percentage differences available. Also, have your students ask the agents for available discounts (e.g., compact car, over age 65, good student).

1. Three methods of defense against a liability claim are:

- Prove you have exercised a proper degree of care.
- Show contributory negligence.
- Prove that the injured person was aware of the risk or voluntarily exposed himself to it.

ANSWERS TO CHAPTER QUESTIONS

2. Under the life value approach, Larry should purchase \$610,000 of liability insurance.

$$\$10,000 \text{ current net worth} + (\$15,000 \times 40 \text{ years}) = \$610,000$$

3. Umbrella policies offer coverage against slander and libel. Comprehensive liability policies do not.

4. Auto insurance covers liability exposure only when you are behind the wheel of your car; comprehensive liability insurance covers a multitude of liability exposures (on the premises, off the premises, and so forth).

In addition, auto insurance covers physical damage to the insured's property (i.e., his or her car) as well as physical damage liability for another's property.

5. The insurance company would pay each a maximum of \$33,333.

His policy will pay no more than \$100,000 for any accident no matter how many people are involved.

6. One should self-insure rather than buy collision insurance if

- he has enough money in an emergency fund to be able to replace his car if it is damaged or stolen, or
- his loss record indicates that his average annual repair bill for damage to his car caused by accidents for which he was at fault is less than his annual insurance premium.

7. The reserve limit would probably be \$6,400.

\$500 medical expenses + \$1,000 loss of income + \$100 miscellaneous expenses + \$4,800 pain and suffering (3 times the total of medical expenses, loss of income, and miscellaneous expenses)

8. Insureds under state insurance plans are normally denied both collision and comprehensive coverage.

9. Ron's annual premium will increase by \$300.

Under the California safe driver plan, a reckless driving conviction warrants three points and three points warrant a 150 percent increase in rates. (150 percent $\times$ \$200 premium = \$300 increase.)

10. Proponents of no-fault auto insurance feel that it would solve the following problems.

Claims would be paid more promptly since litigation would be denied and payment would be made by the insured's insurance policy.

Claimants would be treated equally and receive adequate reimbursement.

Insurance premiums would be reduced because less of the premium dollar would have to go for legal defense and other administrative costs due to claims.

Opponents of no-fault insurance feel that it would create the following problems.

It would deny people their legal right, under the tort liability system, to receive whatever compensation they deemed necessary in excess of the benefits provided by the no-fault plan.

If attorneys are unable to get involved representing a person's individual rights, that person may not receive equitable or personal treatment from the insurance industry.

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

Student-Oriented Case Problems

1. Sally should buy auto insurance. (Everyone who owns and operates his own automobile should carry auto insurance, particularly in the area of public liability.)

Because her car is so old, we recommend she not buy collision insurance. She should buy the coverage and limits shown in the table on the next page.

Sally has three points. Under the California safe driver plan, her rates would increase by 150 percent.

To reduce her rates, she can do any of the following:

- Drive carefully for the next three years so that she can have a no point rating under the safe driver plan and get a 150 percent reduction.
- Try to get the discount allowed to students with a B average or better in school.
- Apply for a compact car discount.

2. The Hansons are in phase 3 of their liability exposure because they are making a good salary and their net worth is between \$25,000 and \$100,000. Larry's insurance limits, according to Table 7-1, should be \$100,000, and should be added to the Hansons' homeowners policy under the comprehensive liability section.

Type	Amount	Reason
Bodily injury	\$50,000/\$100,000	Although her present net worth is small, she is young and has a lot of years of potential earning ahead of her.
Property damage liability	\$10,000	It is easy to imagine an accident involving \$10,000 worth of damages, even if you merely destroy a telephone pole.
Uninsured motorist coverage	Maximum limits allowed by state	It protects you against the hit-and-run driver as well as those who are uninsured and cause an accident.
Medical expense payment	\$5,000	It is relatively inexpensive and would be helpful if Sally drives classmates who may not have health insurance of their own.
Comprehensive	Full coverage	Because the car is so inexpensive the difference in premium between full coverage and a deductible would be very small; it would not pay to assume the greater risk of a deductible.

Chuck and Nancy Anderson

Insuring against the Financial Calamity of a General Liability Suit

1. The Andersons should raise the comprehensive liability limits to \$100,000 on their homeowners form 3 policy for an extra \$10 a year because they have a net worth greater than \$25,000 and are becoming more financially visible.
2. The insurance expenditures on their income statement would be increased by \$10 a year.

Chuck and Nancy Anderson

Insuring against the Financial Calamity of an Auto Liability Claim

1. The Andersons should raise their bodily injury and property damage liability limits to 100/300/25, and their medical expense limits to \$5,000. The liability limits should be raised because the Andersons' financial visibility has increased and the car represents their greatest liability exposure. Medical expense limits should be raised to \$5,000 because Mrs. Anderson often chauffeurs her young children's friends, who may or may not be provided with health insurance by their parents.

Collision damage coverage should be dropped from the compact car because the cost of retaining such coverage is high in relation to the

value of the car itself. At this time the Andersons have enough money in their savings account not only to cover the potential collision damage on the compact car but also to carry a \$100 deductible for collision coverage on the other car (as well as a \$50 deductible for their comprehensive coverage on both cars). As long as their driving experience remains the same, they will be money ahead by self-insuring.

They should add uninsured motorist coverage to protect themselves against loss due to uninsured or hit-and-run drivers. (Remember, uninsured motorist does not include collision—but it does cover everything else.)

2. The coverage we recommend would cost \$641 a year. Thus, their insurance expense on their income statement will be decreased by \$102.

The costs of the recommended changes combined with existing coverage that the Andersons should keep are outlined below.

Coverage	High Horse-power Car	Compact Car
Liability 100/300/25	\$240	\$196
Medical expense (\$5,000)	21	21
Comprehensive (\$50 deductible)	49	38
Collision (\$100 deductible)	137	0
Uninsured motorist coverage (15/30)	14	14
SUBTOTAL	\$461	\$269
Hot car surcharge (30%)	139	0
Multiple car discount (25% discount on cheaper car)		(67)
Good driver discount (20% on both cars)	(120)	(41)
NET ANNUAL PREMIUM	\$480	\$161
TOTAL PREMIUM	\$641	

Objective Questions

SAMPLE TEST QUESTIONS

Circle the letter of the correct answer to each question.

1. In which of the following situations could you NOT be held liable for the accident that occurred?
 - a. You return to your automobile after grocery shopping and find that the emergency brake has broken loose and your car has rolled into the car behind it.
 - b. You run your shopping cart over the heel of the woman in front of you at the check-out stand.
 - c. You take your best friend to a baseball game, sit in a box along the third base line, and a line-drive foul ball breaks your friend's wrist.
 - d. Your son runs into a neighbor on the sidewalk with his bicycle.
2. An insurance company must inspect the insured's property before granting liability insurance coverage.

True False
3. The maximum amount of money that can be paid by an insurance company for your defense in liability suits is the face amount, or total liability coverage, of the policy.

True False
4. If your dog were to chew up your neighbor's carpet, your comprehensive liability policy would pay for the damage done to the carpet.

True False
5. If you purchase bodily injury protection under your single-limit auto policy, you are automatically provided with property damage liability coverage.

True False
6. Your auto insurance can be canceled if you are convicted of three traffic violations in one year.

True False
7. You can combine property insurance and liability insurance into one policy.

True False
8. Your auto policy will pay up to \$100 for loss of or damage to luggage left in your car.

True False
9. The maximum benefit for medical expense under a comprehensive liability policy is \$500 per occurrence.

True False

10. You cannot make a profit off liability insurance by insuring yourself with more than one policy.

True

False

11. The existing no-fault insurance laws vary in the way they treat
- a. the amount to be paid for the insured person's medical or funeral expenses
 - b. the amount to be paid a person hired to perform essential services that an injured nonincome producer is unable to perform because of injuries
 - c. conditions allowing the right to sue
 - d. (All of the above)

Essay Questions

1. What impact has comparative negligence had on the cost of comprehensive liability insurance? Why?
2. How does an umbrella liability policy behave like an "umbrella"?
3. How should you behave when confronted by a claims adjuster?

Objective Answers

ANSWERS TO SAMPLE TEST QUESTIONS

1. c Your friend went to the baseball game aware of potential danger. It was through no negligence of yours that the accident occurred.
2. F Insurance companies may inspect your property prior to granting liability insurance coverage, but an inspection is not required.
3. F The amount of money your insurance company spends, outside of settlement payments, has nothing to do with your policy's face amount. The company will pay the full cost of these supplementary benefits, no matter how high they run.
4. T Damages from the acts of animals are covered.
5. T Your auto policy single-limit packages several liability coverages together. Both bodily injury and property damage are part of the same liability coverage package.
6. T If those violations are "moving traffic violations," your policy can be canceled. More than likely, however, the insurance company will merely raise your rates.
7. T If you purchase a homeowners policy, you can combine both liability and property coverage in one policy.
8. T The rest of the loss must be paid by your property insurance policy.
9. F There is no maximum per occurrence. The maximum per person ranges from \$500 to \$1,000.
10. T Liability policies contain other-insurance clauses just as property insurance policies do.
11. d The existing no-fault laws vary in the way they treat almost everything.

Essay Answers

1. Premiums have risen because the cost of litigation has risen. Since the degree of negligence must be determined, necessitating legal action, more liability cases are ending up in court, thereby driving up costs.
2. Umbrella liability policies (also called catastrophic liability policies) extend liability coverage beyond those limits provided in a homeowners and auto policy. If you maintain underlying limits of \$50,000 on your homeowners policy's comprehensive liability section and \$250,000 per person, \$500,000 per accident, and \$25,000 per cause property damage (or \$300,000 single-limit liability coverage) on your auto policy, this extended coverage will begin without a deductible. This policy operates like an umbrella because it protects you from all manner of liability exposures.

3.
 - a. Be cordial, it could be the beginning of a long relationship.
 - b. Don't volunteer information about your past or present physical condition without first consulting your physician.
 - c. Keep good records of all your expenses involved in your claim.
 - d. Don't file a claim until enough time has elapsed so that you are certain you're feeling as well as you're going to get.

TRANSPARENCY Shopping for Auto Insurance (text Figure 7-1; also reproduced in the *Study*
MASTERS *Guide*)

8 • Health Insurance

After studying this chapter, the students should be able to:

OBJECTIVES

- Determine what their needs for medical expense coverage and for income would be if they were to become sick or disabled.
- Select appropriate deductibles, major medical maximums, coinsurance features, and waiting periods for the policies they would purchase.
- Describe the benefits to which they may already be entitled through employee group programs, Social Security, workers' compensation, and state disability insurance programs.
- Explain the disadvantages of buying double indemnity types of insurance such as aviation ticket policies and accidental death and dismemberment coverage.
- List and describe the various outlets for medical insurance.

There are four important points we feel should be emphasized when teaching health insurance: (1) the need to identify areas of potential financial loss, (2) the wisdom of insuring against catastrophic losses as opposed to routine expenses, (3) the need to measure disability income needs and understand how they can be met by insurance only in combination with other strategies, and (4) the way group policies, Social Security, workers' compensation, and individual policies can be combined to meet health insurance needs. Most students will have their health insurance needs met by their employer. Their dependents will be covered by the employer as well—including, as of 1979, pregnancy and childbirth expenses as normal health expense items.

SUGGESTED APPROACH

1. *Identify areas of potential financial loss.* Identify for your students the two areas of potential loss they must consider when determining their need for health insurance: (1) medical expenses due to treatment of health problems and (2) loss of income due to inability to earn a living while treatment is being administered and/or during convalescence. Too often people think only about the medical expense side and forget about disability income. Your students will need help in learning to determine their needs in both areas.

In regard to income disability needs, a form (Fig. 8-4) is presented in the text (and also in the *Study Guide* and in the transparency masters at the end of this guide) to help students calculate such needs. This procedure is simpler than the one used in prior editions. If you favor the old, more mathemati-

cally pure procedure for determining disability income needs, you will find it reproduced in the appendix to this chapter.

It is impossible to predict maximum medical expense exposure against health risks. Unlike property insurance, the extent of possible financial loss due to illness cannot be measured before that loss occurs, and, like liability insurance, the size of the loss could be so great that a person could not pay for it—either with what the person has or with what he or she could possibly earn. Therefore, we suggest that you analyze in class the insurance mechanisms that are available. Rather than trying to quantify the unknown, the students should buy the broadest type of policy they can.

Be sure your students understand the differences between the various types of coverages offered and the advantages and disadvantages of each so that they can select the most comprehensive policy for their needs. Emphasize that cost should not be a primary determinant of which policy they buy, but that they can reduce the cost by reducing the amount of first-dollar coverage. Focus their attention on the group policy section beginning on page 166 of the text so that they have a perspective of what coverage they're likely to have already.

2. *Insure against catastrophic loss instead of against routine expenses.* Insuring against routine expenses is nothing more than prepaying expenses. You can point this out to your students by comparing premiums with the benefits payable under general medical policies in your area or showing the cost differences as you raise deductibles and stretch out waiting periods. Point out to them that they can better afford to pay out the small claims from their income or emergency reserve. They should be most concerned with those types of expenses whose size could bankrupt a family—expenses caused by major health catastrophes. We propose that you introduce to your students the “thought process” described below and help them learn how to apply it when selecting health coverage.

- Look for a major medical type of policy with broad coverage and maximum limits of at least \$100,000 lifetime benefits, with automatic restoration privileges.
- Design the deductible and coinsurance requirements so that you will never have to pay more than your emergency assets can withstand. For example, if you have \$500 in emergency assets, look for a plan that pays 100 percent of all expenses up to \$100,000 above a \$500 deductible; or a policy that pays 80 percent of all expenses (with no deductible) up to the first \$2,500, then 100 percent of all expenses beyond that up to \$100,000; or a policy that pays 80 percent of all expenses above \$100 deductible, then 100 percent of all expenses above \$2,000. Select the plan that costs the least in annual premium.

The advantages of such an approach are that one will be covered in case of a catastrophe and will know his maximum risk exposure (i.e., the amount of his emergency assets), no matter what health problem arises. By helping your students fix their total potential out-of-pocket loss, you will enable them to plan effectively and with confidence.

3. *Meet disability income needs.* Disability income needs pose a problem not because they rise as inflation erodes the purchasing power of the dollar,

but because most policies provide a fixed income that does not keep pace with rising needs. You might use Figure 8-A to help explain this to your class.

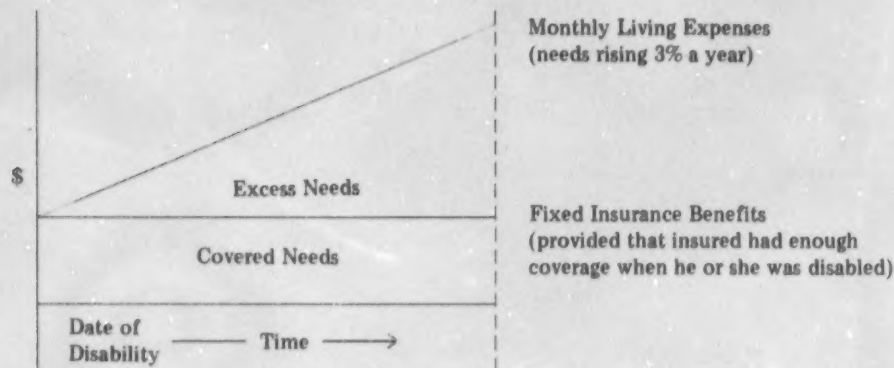


Fig. 8-A. Living expenses increase because of inflation, but the insurance benefits stay fixed.

This problem is further compounded because the insurance industry does not allow a person to buy disability insurance beyond certain participation limits (i.e., 50 percent of current salary). To meet the total need, a person would have to purchase benefits greater than those he or she would need today and then, should the person become disabled, invest that excess income to provide money in the later years when his or her needs exceed the fixed income payments. Figure 8-B can be used to explain this strategy.

The only bit of insurance buying strategy you might encourage your students to use to "beat the system" if their needs warrant it would be to first buy an individually issued policy for the maximum limits their salaries allow

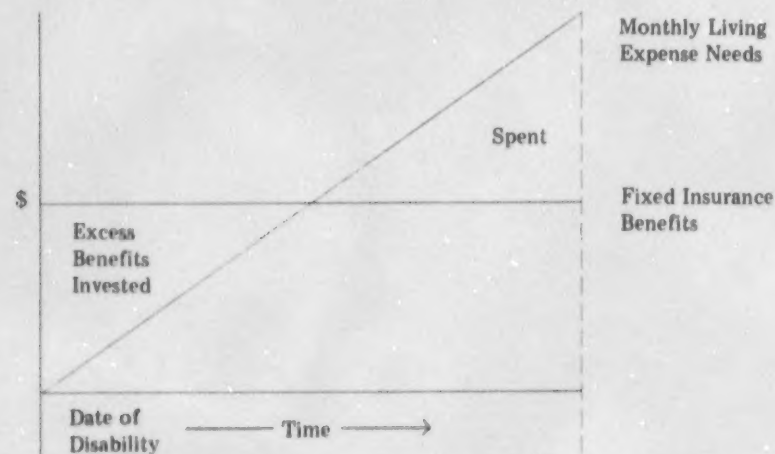


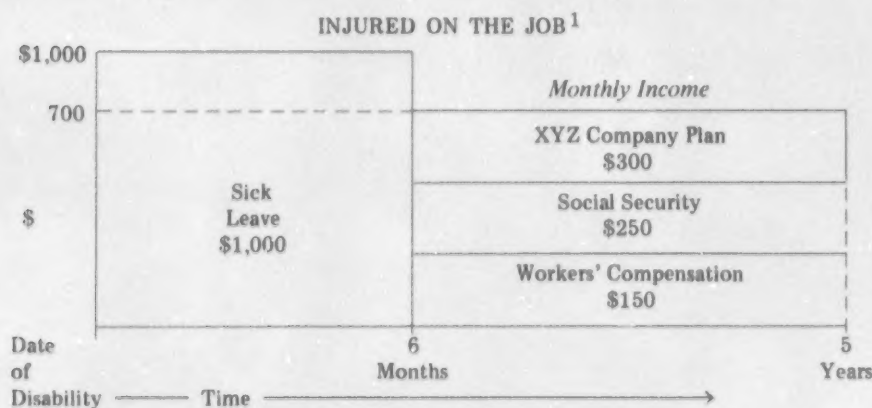
Fig. 8-B. Buying too much insurance would enable the recipient to invest some income to keep pace with inflation in later years.

and then buy a group policy (one that does not have participation limits requirements) through their company or some other association for the extra income they will need. Caution your students that they cannot first buy the group policy and then the individual one because, if they do, they will already have existing coverage that the individual policy will count in its determination of the amount of benefits it can provide. For example, if someone with a salary of \$600 a month already had \$200 a month coverage from a group plan, an individual policy (with participation limits of 50 percent of his salary) could be written to supply only another \$100 a month in benefits so that the total applicable benefits would not exceed \$300. Or, they could buy a policy whose benefits will automatically increase if they became disabled. By the time this book is in print, there should be more companies than Paul Revere writing disability policies that have an automatic benefit increase capability. You should explore the availability of this type of policy in your area.

Your students should compare "own occupation" coverage and "residual" policies. If the insured wants to return to his or her own occupation on a part-time basis, if he or she is disabled, the residual policy is best. In all other situations, the own occupation coverage is more desirable.

4. *Interrelate possible coverage alternatives.* It is helpful, we have found, to use diagrams to explain how various forms of disability income interrelate. You can show when Social Security will begin and in what amounts, when workers' compensation may begin and end, and how a group policy may overlap these underlying coverages.

Here is an example you might use. John Smith earns \$1,000 a month from XYZ Company and he is single. XYZ Company pays up to six months' sick leave (his normal salary for up to six months) and has a long-term disability income policy that guarantees 70 percent of his monthly salary for up to five years. His average earnings for Social Security purposes are \$5,400 a year. If he became totally and permanently disabled as the result of an injury on the job, he would qualify for \$150 a month in workers' compensation benefits from his state (Fig. 8-C). If the disabling injury occurred off the job,



¹He qualifies for \$150 a month in Workmen's Compensation benefits in his state.

Figure 8-C. Payments to John when disabled as the result of an on-the-job injury.

however, XYZ Company would pay \$450 instead of the \$300 possible when workers' compensation entered the picture. The sick leave payments and Social Security are the same in either case.

You can then overlay a student's needs to determine how well the income sources will match the needs. If there are gaps in coverage, students can perhaps buy individual policies to make up the difference. If they need to buy their own insurance, encourage them to use the shopping guide provided in the text and in the *Study Guide*. (The same shopping guide is also provided in the transparency masters at the end of this guide.)

Dr. Jones was a successful dentist earning \$60,000 a year. Since he and his family were spending about \$3,500 a month on normal living expenses, Dr. Jones was concerned about protecting that spending ability were he to become disabled. Dr. Jones was continually barraged with solicitations to purchase disability income insurance, particularly from the various medical and dental associations of which he was a member. Each offering seemed to be advertising cheaper rates, higher benefit limits, and shorter waiting periods. Dr. Jones decided to buy several of these policies totaling \$5,000 a month in benefits. Since he worked with his hands in his profession, he purchased own occupation coverage. His annual premium from all these policies was \$2,000 a year.

Unfortunately, a year ago Dr. Jones became disabled and once the 30-day waiting period expired, he submitted a claim to the various insurance companies for benefits. He was dismayed to learn that he could only receive \$3,333.33 a month, not the \$5,000 a month that he'd been paying for. When questioning the insurance companies, he learned that two of the five policies have participation limits that restrict the coverage from "all applicable coverages" to 66-2/3 percent of his salary at the time he was disabled, or \$40,000 a year, or \$3,333.33 a month.

Besides this disappointment, Dr. Jones found that his disability was only partial and that he could work half time. Of course, if he could work only half time, he could earn only \$30,000 a year (\$24,000 after taxes) or half his original income. However, if he did go back and work in his own occupation, all disability income benefits from his insurance policies would stop. Dr. Jones faced the sad dilemma of staying home and receiving \$3,333.33 in benefits or working half time and earning \$2,000 a month (after taxes). Dr. Jones is not a happy man.

SAMPLE CASE

1. Invite a local representative of the Social Security Administration to discuss how a person qualifies for Social Security and what benefits he is entitled to. Also ask him to explain how benefits are, in essence, tied to inflation because of annual legislated benefit increases.
2. Invite the director of benefits of a major corporation in your town to talk to your class about employee group plans: what they cover, who pays the costs, portability of plans if the employee leaves the company, employer-sponsored benefits for dependents, and benefits (if any) after retirement.

GUEST LECTURE IDEAS

ADDITIONAL MATERIALS AND ACTIVITIES

1. Schedule a class debate on the advantages and disadvantages of independent association plans as opposed to those of commercial policies and HMOs. Have members of your class investigate what is available in your area and report their findings to the class.
2. Research under which conditions or occupations "own occupation" coverage may be better than residual coverage. Talk to various insurance agents who sell both.
3. Research which companies in your area offer disability income policies (such as Paul Revere's) with benefits that increase each year you are disabled. Report to the class the terms of these policies and cost comparisons with normal policies.

ANSWERS TO SAMPLE TEST QUESTIONS

1. It is difficult to determine medical expense needs because one can't measure the amount of potential loss.
2. Deductibles reduce the cost of the policy because they pass to the policyholder the burden of absorbing the first dollars of any loss. Also, they allow you to pay for inexpensive things you can be pretty sure will happen.
3. I recommend that Lucy purchase the major medical policy with the \$200 deductible for \$225 a year. If Lucy doesn't expect her loss experience to worsen and has \$200 in an emergency fund to cover the deductible in case it does, she will spend an average of \$25 a year less than if she had bought the hospital and surgical expense policy for \$350 a year.

Lucy's medical expenses have averaged \$80 a year for 10 years. If you add the average annual loss to the annual premium for the \$200 deductible major medical policy, you have an annual potential cost of \$305.

4. True insurance protects against the risk of financial loss from something that might possibly (rather than probably will) occur. A prepayment plan normally covers routine expenses that are relatively small and are likely to occur frequently; it is much more expensive than true insurance and requires annual premium payments that closely approximate the amount of benefits available.
5. Jerry will have to pay the \$350 coinsurance cost plus the \$100 deductible for a total of \$450.

$\$800 + \$400 + \$500 + \$150 = \$1,850$ total cost
 $\$1,850 - \$100$ deductible = \$1,750
 $\$1,750 \times 20\%$ coinsurance factor = \$350
 $\$350$ coinsurance factor + \$100 deductible = \$450

6. Factors that should govern my decision concerning the length of the waiting period for a disability income policy are
 - the size of my emergency fund,
 - what I can get in the way of sick pay or other benefits from my employer, and
 - how long the benefits from my employer will provide me with an income before extra help is required.
7. He would receive \$400 a month.
8. The renewability provision that offers the most safety to the policyholder is the noncancellable, guaranteed renewable type of policy because these policies cannot be canceled for any reason nor may the premiums be raised.
9. A health insurance medical expense policy pays for medical services. An independent association plan provides the services themselves.
10. Double indemnity is defined as the responsibility an insurance company assumes to pay twice the stated policy benefit limits if the insured is injured in a specific way. These types of policies are valueless: the way you get the injury has nothing to do with the amount of benefits you need.

Student-Oriented Case Problems

1. Jeff's company would pay him \$350 a month after he has been disabled for three months.

Yes, he does need more disability income insurance.

If Jeff buys a policy of his own, he should buy insurance that will pay him \$150 a month (he needs \$500 a month to live on) with a one-year waiting period (his \$3,000 savings account will allow him to self-insure for the first three months and make up the difference between his company's benefits and his own needs for the 10 months after that).
2. Mary Ann must be concerned about the cost of a catastrophic illness. With only \$1,200 in a savings account and a sporadic salary, she would have no way of paying the medical expenses associated with a long illness. All three policy selections cost \$200 a year, and so the benefits are more important than price in the policy chosen. The combination hospital surgical policy covers only about half of the normal daily semi-private hospital room rate and offers no coverage for outpatient care. The general medical policy covers the expenses of the doctor only, not the expenses of hospitalization, drugs, and so on. Only the major medical policy covers all expenses (hospital, physician, drugs, lab, etc.) and offers limits that would cover a catastrophic illness or accident. More-

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

over, her maximum out-of-pocket expenditure per illness would be \$700 (\$200 deductible plus 20% of \$2,500). Her \$1,200 in savings would be an adequate emergency reserve.

Chuck and Nancy Anderson **Insuring against a Financial Calamity due to Loss of Income**

Chuck needs no additional disability insurance; he is covered adequately by his employer.

Figure 8-D shows how we used the procedure for determining disability income needs in answering this question. Chuck's existing insurance coverage (\$625 a month from his company beginning in six months) amounts to \$7,500, and so his net need for disability income insurance is actually a surplus— $\$7,500 - \$2,455 = \$5,045$. However, because inflation will increase his needs each month, he would have to invest this monthly surplus in the early years so as to have sufficient income in the later years to meet his inflated needs. (Note that in determining the amount of Chuck's Social Security benefits, we used only those for a disabled worker—\$288.40 a month—and disregarded any Social Security allotment to the children of a disabled worker, as it would be available only while the children remain minors.)

NAME	<u>Chuck Anderson</u>	
DATE	<u>April 1979</u>	
STATEMENT OF INCOME DISABILITY NEEDS		
1 Annual Living Expenses		<u>\$14,220</u>
2 Adjusted Annual Living Expenses		
Tax savings	<u>\$2,230</u>	
Insurance premiums waived	<u>1,175</u>	
Other		
3 Spouse's Income	<u>\$4,000</u>	
4 Investment Income	<u>900</u>	
5 Social Security Benefits	<u>3,460</u>	
6 TOTAL ADJUSTMENTS	<u>11,765</u>	
7 Net Annual Disability Income Needs		<u>\$2,455</u>

Fig. 8-D. Statement for use with Anderson case problem.

Objective Questions

SAMPLE TEST QUESTIONS

Circle the letter of the correct answer to each question.

1. Coverage of which of the following expenses would constitute a prepayment plan?
 - a. Surgical expenses
 - b. Hospital room and board charges
 - c. Doctor's office visits
 - d. Hospital drugs and X rays
2. Which of the following individuals would not qualify for Social Security disability income payments if he were disabled today?
 - a. A man 30 years old with five years of work credit since his twenty-first birthday
 - b. A man 35 years old with six years of work credit since his twenty-fifth birthday
 - c. The wife of the man described in answer "b" with no children
 - d. The wife of the man described in answer "b" with four children
3. Harry Jones (age 65) was in the hospital for 75 consecutive days last year. He had \$40 worth of expenses each day—a total cost of \$3,000. How much of those expenses were paid by Medicare?
 - a. \$3,000
 - b. \$2,316
 - c. \$2,285
 - d. \$450
4. Which type of medical expense insurance will cover the full cost of physiotherapy, but not the full cost of physician expenses?
 - a. Hospital expense
 - b. Surgical expense
 - c. General medical
 - d. Major medical
 - e. Comprehensive medical
5. Which type of medical expense insurance will cover radiology expenses for up to three years and might have a \$750 deductible?
 - a. Hospital expense
 - b. Surgical expense
 - c. General medical
 - d. Major medical
 - e. Comprehensive medical
6. Which type of medical expense insurance is little more than a prepayment plan?
 - a. Hospital expense
 - b. Surgical expense
 - c. General medical
 - d. Major medical
 - e. Comprehensive medical

7. Bill Bryan has a major medical plan with a 20 percent coinsurance feature. Last year he ran up \$5,000 worth of covered expenses. If Bill's policy had a \$750 deductible, how much did Bill end up paying?
 - a. \$750
 - b. \$1,000
 - c. \$1,600
 - d. \$2,000
8. The premium for a basic disability income insurance policy could be altered if the policyholder were to
 - a. move to a nearby town
 - b. move more than five miles from a fire department
 - c. change to a more hazardous job
 - d. receive a salary increase
9. Which of the following could affect the price of health insurance?
 - a. The type of coverage desired
 - b. The size of the deductible
 - c. The length of the policy term
 - d. The type of renewability provision
 - e. (All of the above)
10. If you are covered by a residual disability income policy, you must return to your job part-time, if able, yet still may receive partial monthly insurance benefits.

True
False
11. The annual fee to an HMO entitles you to full use of the health care services provided by that HMO at no additional cost.

True
False

Essay Questions

1. Describe the differences between a hospital expense policy and a hospital indemnity plan? Which type of policy best handles your hospital needs?
2. How can you construct a disability insurance program that keeps pace with inflation should you become disabled?
3. What is the major difference between health insurance policies and HMOs?

Objective Answers

ANSWERS TO SAMPLE TEST QUESTIONS

1. c Doctor's office visits are a routine and frequent occurrence; premiums would closely approximate the actual costs of such visits plus policy service charges. Such a policy would be nothing more than a prepayment plan.
2. c A wife with no children (unless she were 62 years of age) would receive no disability income benefits under Social Security. We are presuming that the wife of a 35-year-old man would not be 62.
3. c Medicare paid all but the first \$144 for Harry's first 60 days (\$2,256), but only \$4 a day (\$40 - \$36) for the next 15 days (\$60) for a total payment of \$2,316.
4. a See Table 8-2 in the text.
5. d See Table 8-2 in the text.
6. c See Table 8-2 in the text.
7. c Bill must pay his \$750 deductible plus \$850, which is 20 percent of the remaining \$4,250.
8. c Your rates could go up due to the change-of-occupation provision.
9. e
10. T The insured may receive a portion of the total policy benefits in the same proportion as his salary after disability is to his salary before disability.
11. T HMOs provide a prepaid health plan that covers the member 100 percent in return for one annual fee.

Essay Answers

1. A hospital expense policy *reimburses* you up to certain limits for actual expenses incurred, while hospital indemnity policies pay a *fixed dollar amount* for each day you're hospitalized regardless of how much your hospital costs actually are. It is always better to be reimbursed for actual expenses rather than to guess at what the costs might be.
2. There are two ways to deal with the inflation issue:
 - a. Buy a policy like the Paul Revere policy, which raises its benefits automatically each year a fixed percentage of the original benefit amount, and hope that the increase approximates inflation.
 - b. Buy benefits in excess of your needs today so that you can invest the surplus income in the early years of disability and have sufficient income to supplement the disability insurance benefits in the later years.
3. HMOs encourage *preventive care* (through frequent medical checkups and the like) by charging a fairly large monthly premium; the idea is you've paid for it, so you might as well use it. Health insurance policies reimburse you for actual service you use, motivating people to be some-

what careful, from a cost point of view, about what services they use and when. In essence, HMOs provide *prepaid health care* while policies provide *pay-as-you-need* health care services.

APPENDIX MATERIAL Procedure for Determining Your Disability Income Needs (From first and second editions of the text; may be reproduced for classroom use)

TRANSPARENCY MASTERS 1. Statement of Income Disability Needs (blank form from text Figure 8-4)
2. Shopping for Health Insurance (text Figure 8-6)

These forms have also been reproduced in the *Study Guide*.

Procedure for Determining Your Disability Income Needs

APPENDIX

In addition to the costs of medical services, health insurance can cover loss of income caused by disability due to accident or illness. Although your medical expense needs can be estimated only roughly, you can determine how much disability income you might need by using the following procedure (Fig. 8A-1). Of course, this procedure will have to be repeated whenever your needs or your assets substantially increase or decrease.

1. *Annual Living Expenses.* Determine your current level of annual living expenses, based on the figures you computed for your income statement in Chapter 3.
2. *Adjusted Annual Living Expenses.* Make adjustments in categories that would be affected if you were to become disabled. Since disability income payments are not taxed, you need not allocate money for income taxes. Take into account also that some expense categories such as transportation and entertainment may be reduced if you become disabled. Furthermore, if your insurance policies have waiver of premium clauses that enable you to retain insurance coverage without paying premiums while disabled, subtract the amount of the annual premiums from your living expense needs.
3. *Spouse's Income.* Determine how much income your spouse would earn if you became disabled and he or she continued working or returned to work.
4. *Social Security Benefits.* Check the Social Security addendum to determine the level of benefits you would be entitled to if you have worked long enough to qualify for Social Security. Social Security benefits are paid only if you are unable to perform any gainful employment and the disability is expected to last at least 12 months. They will begin after you have been disabled five months.
5. *Net Annual Disability Income Needs.* Subtract the items (steps 2, 3, and 4) that may reduce your living expense needs if you become disabled to arrive at your net annual disability income needs. These are the needs that must be met with income from other sources.

TABLE 8A-1
INFLATION FACTORS

Years	10	20	30	40	50	60	70
Inflation factor	12	27	41	75	113	153	200

6. *Average Annual Inflated Disability Income Needs.* Adjust your net needs to allow for the effects of inflation. Your spouse's income and your Social Security benefits can probably be assumed to rise at about the same rate as inflation. Your remaining needs, however, will probably be met

Note: From the first and second editions of the text; may be reproduced for classroom use.

Name _____

Date _____

STATEMENT OF INCOME DISABILITY NEEDS

1 *Annual Living Expenses* _____

2 *Adjusted Annual Living Expenses*

Tax _____

Insurance _____

Other _____

3 *Spouse's Income* _____

4 *Social Security Benefits* _____

5 *Net Annual Disability Income Needs* _____

6 *Average Annual Inflated
Disability Income Needs* _____

Age 85 Minus Present Age _____

Inflation Factor _____

Total Inflated Net Disability Income Needs _____

7 *Annual Income from Investment* _____

Assets for Investment _____

Annuity Factor _____

8 *Annual Disability Income Insurance Need* _____

Fig. 8A-1. Form to use for determining one's income disability needs.

by fixed income sources (i.e., insurance policies that promise to pay a certain number of dollars each month, regardless of the purchasing power of those dollars). You must therefore "inflate" your needs to see how much money you will need if the general cost of living, as measured by the consumer price index, continues to rise at about 3-3½ percent a year as it has historically for the last 35 years. Even though inflation may be in the 6-8 percent range over the next few years, we believe that 3½ percent is still a good long-term target. For example, if you need \$1,000 a month to live on this year, you will need \$1,030 a month next year to buy the same things.

Figure the number of years between your current age and age 85—a conservative life expectancy. For example, if you are 22 years old, there will be 63 years until you turn age 85. If you have reason to think that you will live beyond age 85, add a couple of years to this difference.

Select the inflation factor (Table 8A-1) that corresponds to the number of years between your current age and age 85. Table 8A-1 gives inflation factors that represent the effect of 3 percent inflation on the purchasing power of the dollar. (Factors for intermediate years can be found in the 3 percent column of compound interest Table B in the text.) Multiply this factor by your net disability income need (step 5) to arrive at your inflated disability income needs for the rest of your life.

Divide this total by the total number of years between your present age and age 85 to determine your average annual inflated need. This annual figure will be greater than your present annual needs because it accounts for rising needs in future years. For example, if you needed \$1,000 a year for 40 years, you would actually need \$75,000, or \$1,875 a year as derived from Table 8A-1.

TABLE 8A-2
ANNUITY FACTORS

Years	10	20	30	40	50	60	70
Annuity factor for 5 percent savings account	7.7	12.5	15.4	17.2	18.2	18.7	19.0
Annuity factor for 7 percent investment	7.0	10.6	12.5	13.4	14.0	14.2	14.3

7. *Annual Income from Investment.* Divide the total asset figure you would like to invest by the annuity factor (Table 8A-2). The years in Table 8A-2, as in Table 8A-1, represent the number of years between your current age and age 85. The result will be the annual income your investments will produce if invested either in a 5 percent savings account or in securities yielding 7 percent.

You may be able to use your assets to meet some of your disability needs. For example, if you were disabled, would you still want to save for a European vacation? Would you still need a second car? If you converted your assets into cash and invested them, they could produce a yield that would help meet your expenses. For example, \$10,000 in-

vested at 5 percent could help defray annual living expenses by \$500. If, however, you were willing to dip into the principal of your investment as well as the interest, you could establish an annuity that would pay you a certain sum each year for the rest of your life. Used this way, \$10,000 invested at 5 percent would produce \$582 a year for 40 years. Of course, if you annuitize your investment, you will have nothing left when the annuity runs out. You will have more money to use each year, however, than if you took the investment's income yield only.

Instead of using all your assets to cover a portion of your annual expense needs each year, you may find it more economically sound to use up some or all of your investment assets before relying on a disability income policy. For example, if your assets would cover your living expenses for the first six months, you could purchase a disability income policy with a six-month waiting period and thus save money on premiums.

8. *Annual Disability Income Insurance Need. Subtract the annual income from your investments (step 7) from your annual inflated disability income needs (step 6) to see how much insurance you will need to cover the remaining needs.*

9 • Life Insurance

After studying this chapter, the students should be able to:

OBJECTIVES

- Explain why they do or do not need life insurance.
- Determine how much coverage they need now, taking into consideration probable expenses and probable sources of income (including Social Security and returns from investments).
- Explain how one's needs for life insurance change over time—depending on the number and age of one's dependents, one's age, assets, and lifestyle—and therefore necessitate periodic reevaluation.
- Describe the five basic variables in life insurance policies: protection, savings, face amount, policy period, and premium.
- Explain the difference between term insurance and cash value insurance and describe the types of policies available in each of these two categories.
- Describe the clauses that make up the life insurance contract.
- Shop for life insurance, taking advantage of cost differences from one company to another.

We suggest that the instructor emphasize in class the method by which a person determines his or her needs for life insurance. As you do so, help your students to answer the following questions:

SUGGESTED APPROACH

- Do I need life insurance at all?
- If I do need insurance, how much do I need?

Your students can readily answer the first question if they list the people who depend on them financially. To answer the second question, have them use the eight-step procedure presented in the text to compute the mathematical difference between the amount of their investment assets and the extent to which others are financially dependent on them. (Blank copies of the eight-step procedure form are given in the *Study Guide*.) Because this procedure uses present value, a fairly sophisticated financial technique, it may require some extra effort on your part before your students can apply it comfortably. But the benefit to your students of understanding how to apply this procedure will more than compensate for the extra effort required.

Graphs and charts can be used to show how a family's needs change over time. You might encourage your students to graph their needs by plotting them at different points in time. Have them complete an eight-step proce-

ture to determine their needs assuming they die this year, five years from now, 10 years from now, and so on. This will provide the plot points for their graphs.

Help your students understand the concept of self-insurance. A policy should not be held forever. Survivorship income needs end when one either is financially independent or has retired. Estate liquidity through the purchase of insurance should be a last resort. Do not actuarially gamble.

Term or Cash Value?

Although we have exercised some restraint in the text discussion of life insurance so as not to present a definitely biased point of view, it is our firm conviction as financial consultants that annual renewable term insurance offers both the most flexible coverage at the least cost, and, in essence, the best coverage. The majority of the life insurance community, because they profit more from the higher commissions on cash-value as opposed to term policies, would differ with our conviction and present some examples and principles intended to disprove the superiority of term insurance. These so-called proofs usually rely on mathematically or theoretically unsound reasoning. Cash-value insurance is nothing more than the combination of decreasing term insurance and a rather low-yield investment. One can almost always do better financially by purchasing term insurance and investing the difference in premiums in a government insured savings account—*providing* one does actually invest the difference.

What is particularly distressing to us is that cash-value insurance is generally all one hears about from the life insurance community. Your students, who are probably least able to afford to tie up their money in long-term low-yield investments, are likely to find themselves being influenced by life insurance agents to buy cash value insurance; they end up buying much less coverage than they really need because of the high cash outlay required for cash value policies. We are asking you to provide a few facts to your students so that they can effectively compare policies and make financially astute decisions. You could greatly help your students by making certain that they understand the following two points:

1. One's need for providing living expense coverage for one's family decreases over time due to the fact that, as one's family ages, they have fewer and fewer years to live.
2. One's need for a life insurance policy ends when one has accumulated assets sufficient both to pay all estate transfer costs and to provide an income large enough to cover one's family's living expense needs for the rest of their expected lives.

Making a wise selection of insurance policies might well be impossible for your students if they talk to the usual life insurance agent without having the kind of background your course can provide. They will hear such things as:

- The "net cost" of cash value is less than term insurance.
- You will need life insurance until you die and term insurance is not renewable beyond age 65 or 70.

- * You are simply "renting" insurance if you buy term insurance, and that rent gets very expensive as time goes by.
- * More cash value insurance is sold than term; people like the Rockefellers, Carnegies, and Morgans all bought cash value insurance, and they were not financially ignorant.

All of these allegations are misleading, as we will briefly try to outline.

1. *The "net cost" approach.* The "net cost" approach subtracts the accumulated cash value from the sum of the total premiums over a specified period of time. The result is the policy's net cost. Sometimes the accumulated cash value is greater than the sum of the premiums, especially with endowment policies. Life insurance agents compare the "net cost" of their cash value policies with the cost of term insurance. What they neglect to consider, however, is what is done with the premium difference between cash value and term policies. This money, if invested at anything more than 4 to 5 percent after taxes, will provide a greater "cash value" at the end of any stated period of time than the cash values in any cash value policy. Therefore, the net cost of a buy-term-invest-the-difference philosophy is going to be less than a cash value policy, even if that policy is "minimum deposited." (Annual cash-value increment is borrowed out each year to pay a portion of the premium and a term addition is purchased with the dividend to keep the coverage face amount level.)

2. *"Your need for life insurance never ends."* How long people need life insurance depends on the size of their dependents' aggregate need and the size and growth of their investable assets. Once their investment assets equal their total aggregate life insurance needs, their need for life insurance ends. And, since one can buy term insurance in many states until age 100, a person never really needs cash value insurance.

Many life insurance agents say that when one's family's living expense needs are met, one must worry about liquidity to pay estate taxes at death. They maintain that cash-value life insurance provides that liquidity. However, a person is better off investing those would-be premiums in a savings account than paying for insurance. For, if a man dies when the insurance company thinks he will (based on life expectancy), he will have paid in more money in the form of premiums and foregone savings account interest that could have been earned by investing the cash value portion of his premium than he will receive from the policy's death benefit. Therefore, one is merely "actuarially gambling" by investing in cash value insurance.

A good illustration of actuarially gambling can be achieved by having the students do the following:

1. Multiply the annual premium of their current (or proposed) life insurance policy times the number of years between today and the year they should die, according to current mortality tables.
2. Subtract that total from the face amount of the policy.
3. Multiply the amount of annual outlay equivalent to the annual premium times the appropriate compound interest factor in Table B for the same number of years as in step 1, at whatever interest rate they feel is achievable.

4. If there is a cash value in their existing policy, multiply this cash value figure times the appropriate compound interest factor in Table A for the same number of years as in step 1 and the same interest rate as in step 3.
5. Add the sums in steps 3 and 4 and compare with the sum in step 2. The surplus in steps 3 and 4 is what they would be missing if they retained their existing policy and died when the insurance actuaries think they most likely will. By trial and error they can work forward in time until the sums for steps 3 and 4 equal the sum in step 2. At that point in time they would be financially indifferent to whether they had insurance or had invested a sum equivalent to the policy's annual premium.

The "gamble" is whether you will live longer than the point of financial indifference. If you die sooner, you would be better off with the insurance. If you die later, you would be better off having invested the money yourself and foregone the insurance. In other words, to make it pay off, you have to die earlier than you are expected to. Also, remember that the amount of actual life insurance one carries in cash value insurance declines over time as the cash values (the insured's money) grow. Also, the beneficiary receives only the face amount of the policy, not the face amount plus what was saved.

3. *"Renting insurance is more expensive than buying permanent insurance."* With term insurance, the insured's beneficiaries receive benefits if he or she dies; with cash value insurance, he or she has a choice of receiving the cash value while alive or the death benefits if he or she dies. However, term insurance operates on the same philosophy as property, liability, and health insurance. They pay a person only if the calamity being protected against occurs. Also, when you consider the opportunity to make money that is lost by investing in cash value insurance, you will see that "owning" permanent insurance provides no advantages.

As one grows older, the price per \$1,000 of term insurance increases, but the number of \$1,000 worth of insurance one needs to buy normally decreases. Thus, the actual premium paid will probably either remain level or decrease. This is the same principle that operates with cash value insurance: as cash values grow, the insurance element decreases.

4. *"Others buy it, why don't you?"* If a person discusses the investment aspects of cash-value life insurance with an insurance agent, the agent is likely to try to make the person feel that he or she should have some amount of cash value insurance to diversify his or her investments. The agent will likely point to some well-known, wealthy individuals who carried cash-value life insurance. But knowing how to make money does not necessarily mean that a person knows how to manage that money.

The above defenses of term insurance should be used to counter arguments made by cash value adherents who maintain that their policies are the only way to go. Naturally, broad generalizations on both sides are inaccurate. Your job should be simply to air both sides of the issue so that students are better prepared to decide for themselves.

A final point that should be carefully considered is the one of meeting one's objectives. A family that wants to save money for a house down payment in four years would have no use for a cash-value insurance investment program designed for long-term savings goals. (There is little or no cash value accumulation the first year in whole life insurance.) Also, that same family may find it needs \$200,000 of life insurance but cannot afford the enormous cash outlay for that much whole life coverage.

Two Other Main Ideas

Regardless of how one stands on the cash-value versus term insurance question, you should point out to your students the value of selecting the lump-sum settlement option if they do select cash value. The advantages of lump-sum settlement are explained in the text.

Stress shopping for rates, as the differences in various companies' rates for similar policies are astounding. (A blank shopping form is provided in the *Study Guide*.) In fact, some companies tend to discourage term insurance through relatively high premiums. Others offer rates 50 percent below other rates in order to attract customers who may ultimately purchase other types of insurance.

1. Frank was 28 years old. When shopping for life insurance, he was intrigued with accidental death and dismemberment (AD&D) insurance because he figured the only way he, at his age, would die would be by accident. Since the annual premium for life insurance reflects mortality rates, Frank should have realized that term life insurance was more expensive than AD&D coverage because more people his age die by sickness and poor health than by accident. If it were the other way around, AD&D would be more expensive. But Frank seemed to be in good health, and so he purchased \$50,000 of AD&D coverage and \$50,000 of annual renewable term. In addition, whenever Frank flew on airplanes, he bought \$100,000 worth of travel accident coverage for 25¢ per \$1,000 of insurance, or \$25. Frank felt he was pretty sharp in the way in which he had analyzed and provided for his life insurance needs. His wife Ronda doesn't, however; she has to leave her two young children at a day care center each morning and go to work 15 miles away. Frank died last year from pneumonia.
2. After paying \$13.25 per \$1,000 of coverage for a whole life insurance policy, Terry found out he could have bought the same amount of term insurance for \$3.25 per \$1,000. However, he was reluctant to confront his agent, who was also his brother-in-law. It might make things a little rough at family get-togethers. But Terry finally decided to do it and asked his brother-in-law to change him from a cash value policy to a term one. After a lot of arguing, his brother-in-law agreed to make the change. Two weeks later Terry found out he could have bought the same coverage for \$1 per \$1,000, rather than the \$3.25 he was paying, if he'd taken the time to shop for competitive rate quotes.

SAMPLE CASES

Moral: Make the right decision to switch to term but don't buy the term policy from the same company that sold you the whole life. Shop for rates.

GUEST LECTURE IDEAS Invite a life insurance agent to talk to the class and have him address the following issues:

- a. Mutual versus stock insurance companies
- b. Par versus nonpar policies
- c. Term versus cash value policies
 1. Costs
 2. Policy term
 3. Commission structure
- d. Insurance on nonworking spouses and children

ADDITIONAL MATERIALS AND ACTIVITIES

1. Have members of your class call various life insurance agents to obtain rate quotes on four or five types of policies to cover one specific situation. (You might provide them with the data they will need to give the agents in order to be sure exactly the same situation is presented to every agent.) Graph the rate dispersion and discuss why the rate differences might have occurred.
2. Distribute to your class copies of *The Insurance Salesman* magazine, a publication aimed at life insurance agents. Have your students become aware of selling techniques highlighted in the magazine's articles, especially the "stumper of the month" section. Forewarned is forearmed!

ANSWERS TO CHAPTER QUESTIONS

1. Methods by which life insurance needs can be reduced are:
 - Have your beneficiaries plan to live at a lower standard of living than the one they presently enjoy.
 - Obtain a higher yield on your assets so that they will grow faster.
 - Build up assets so that you can self-insure a portion of your family's needs.

A person will probably utilize the first method while he is young, thereby passing as much as possible of the financial burden on to his heirs. As he becomes older and more affluent, he will shoulder more of the responsibility for his dependents' needs after his death.

2. Bill can borrow \$3,000—the amount of his policy's cash value. The amount of his insurance that will remain in force is \$7,000—the face value of his policy less the amount borrowed.
3. The amount of life insurance the family needs to buy today is \$198,000.

The discount factor for a savings account and bond portfolio for 55 years is 33 (see Table 9-1 in the text). If you multiply the annual need (\$6,000) by this discount factor, you get an aggregate need of \$198,000—the total amount of insurance Jim should purchase on his life.

4. Guaranteed annual renewable term insurance is the most flexible type of term insurance because its limits can be either lowered or kept the same at your discretion and it can be automatically renewed to age 100 regardless of deterioration in your health.
5. The major advantages of the lump-sum settlement option are that (1) it allows you to consider options not offered by the policy itself, (2) you can invest the proceeds somewhere other than with the insurance company and realize a greater yield on your money, and (3) the unused portion of the policy's proceeds will be able to grow at a greater rate until they must be used.
The disadvantage is the temptation for the heir to spend the money too quickly since he or she will have access to all the proceeds at once. (The solution to this problem is to set up a trust.)
6. I disagree. You need life insurance only if you have dependents who must be provided for after your death and you don't have enough assets accumulated to know that they won't suffer hardship because of a lack of insurance benefits.
7. No! (Emotionalism has no place in insurance decision-making. Unfortunately, however, it is all too often sold by an appeal to the customer's emotions.)

Student-Oriented Case Problems

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

1. It might be more appropriate for Jason to buy the endowment policy if he felt he needed the regular prompting of a premium notice in order to save. (We have used endowment policy here because the cash value of an endowment policy increases faster than that of any other type of cash value policy.)
If they can save money on their own, it might be more advantageous to buy term insurance because the lower premiums on term insurance would probably enable them to buy the amount of insurance they need. (The Bells are young and if Jason were to die, Heather would have a long period to live; therefore, she would need a lot of money, in the aggregate, to provide her with the income stream she would require.) Also, the dollar returns are greater with the buy-term-insurance-invest-the-difference strategy.
There is such a difference in the returns from the two investment alternatives because the cash value of the endowment policy would grow at a guaranteed 2.5 percent a year while a savings account would grow at 5 percent a year.
2. The amount of life insurance Frank would need would be \$80,000. The discount factor for a securities account for 40 years is 20 (see Table 9-1 in the text). If you multiply 20 times the annual need (\$4,000), you get an aggregate need of \$80,000.

Chuck and Nancy Anderson Insuring Chuck's Life

1. Chuck and Nancy need approximately \$107,000 of life insurance. Figure 9-A shows how the eight-step procedure was used to arrive at this answer.
2. If Chuck buys term insurance, it would cost him \$428 ($\$107 \times 4$) the first year. If Chuck buys whole life insurance, it will cost \$1,926 (18×107) the first year.

Term insurance is always the more appropriate form of coverage unless someone cannot save money on his own. (Cash value insurance is not a good investment because the cash values grow so slowly and the finance charges are high.) You come out ahead financially by buying term insurance and investing the difference between the term premium and whole life premium in an insured savings account.

Chuck would definitely want to cash in his present \$20,000 whole life policy because, as you can see by his financial statements, he can save money on his own. He can then purchase \$107,000 of annual renewable term insurance and use the cash value to pay off his furniture and auto loans.

NAME(S) <u>Chuck and Nancy Anderson</u>	
DATE <u>January 1980</u>	
EIGHT-STEP PROCEDURE	
1 Funeral, Administrative, and Estate Tax Expenses	<u>\$17,000</u>
2 Debt Resolution (excluding home mortgage)	<u>6,448</u>
3 Contingency Fund (twice your monthly take-home pay)	<u>5,000</u>
4 College Fund	<u>32,000</u>
5 NET ANNUAL LIVING EXPENSES	
A. Average annual living expenses	<u>\$8,000</u>
B. Spouse's average annual income	<u>1,000</u>
C. Average annual Social Security	<u>5,000</u>
D. Net annual income needs (A - B - C)	<u>\$2,000</u>
E. Number of years in period	<u>50 (death at age 85)</u>
F. Average annual investment rate factor (Table 9-1)	<u>31 (savings, annuities)</u>
G. TOTAL NET INCOME NEEDS (D x F)	<u>\$62,000</u>
6 TOTAL MONETARY NEEDS (1 + 2 + 3 + 4 + 5G)	<u>122,448</u>
7 TOTAL INVESTMENT ASSETS	<u>15,700</u>
8 Your Life Insurance Needs (6 - 7)	<u>\$106,748</u>

Fig. 9-A. Calculation of the Andersons' life insurance needs.

Objective Questions

SAMPLE TEST QUESTIONS

Circle the letter of the correct answer to each question.

1. Which of the following is NOT a variable affecting the type of policy you can buy?
 - a. The policy period
 - b. The savings element
 - c. The way in which benefits are paid
 - d. The premium pattern
 - e. The protection element
2. Which of the following policies has NO savings element?
 - a. Whole life
 - b. 10-year renewable term
 - c. 20-payment life
 - d. Endowment
3. Which of the following is NOT true with regard to a straight life policy?
 - a. As your policy nears the end of its period, more of your premium goes toward building up the policy's cash value than building up protection.
 - b. When you die, your beneficiary will receive both the face amount of the policy and the accumulated cash value.
 - c. The protection pattern is the reciprocal of the savings pattern.
 - d. The straight life policy is a means of forced savings.
 - e. The cash value never exceeds the policy face amount.
4. Which of the following is true with regard to a term policy?
 - a. Term insurance requires a smaller cash premium than any cash value policy for the same face amount of protection.
 - b. Only the policy's beneficiary ever receives any money (except for policy dividends).
 - c. Protection can increase, decrease, or remain level over the policy period depending upon your choice of pattern.
 - d. (All of the above)
5. Which of the following is an allowable means of distributing your life insurance benefits upon your death?
 - a. Lump sum
 - b. Installments over a specific period of time
 - c. Installments for as long as your beneficiary lives
 - d. Fixed amounts at certain points in time
 - e. (All of the above)
6. Which of the following policies requires the highest premium for the same death benefits?
 - a. Paid-up additions
 - b. Straight life policy
 - c. Endowment policy
 - d. Term policy
 - e. 20-payment life policy

7. Which of the following does not affect the premium rate of a life insurance policy?
- a. The size of the policy's cash surrender value
 - b. The length of the policy period
 - c. The face amount of the policy
 - d. The settlement option you select
 - e. The size of the protection element
 - f. (All of the above)
8. You may NOT borrow from your policy an amount greater than the current cash value.
- True False
9. You will pay more for your policy if you pay the premiums quarterly instead of annually.
- True False
10. All life insurance policies pay dividends.
- True False
11. Under the automatic nonforfeiture option, the insurance company transfers your policy coverage to a term policy if you, the policyholder, discontinue your present cash value policy.
- True False
12. Once you have set up a sound life insurance program you can forget about it until you turn 65.
- True False
13. Which of the following factors can reduce your outlays for life insurance?
- a. Buying term insurance, rather than cash value insurance
 - b. Planning for your beneficiary to continue working or to resume working after your death
 - c. Planning to take the lump-sum settlement option (rather than one of the other options) and setting up an investment trust for the settlement proceeds
 - d. Building up other investments as quickly as you reasonably can to reduce future insurance costs
 - e. (All of the above)
14. Which of the following types of life insurance policies offers the most flexible coverage at the least cost?
- a. Annual renewable term
 - b. Whole life
 - c. Limited payment life
 - d. Endorsement

Essay Questions

1. Why is the selection of settlement options the most important cost saving decision you can make about life insurance?
2. Should you purchase life insurance as a way to pay estate taxes? If so, or if not, why?
3. Explain why life insurance needs decrease over time.

**ANSWERS TO
SAMPLE TEST
QUESTIONS**

Objective Answers

1. c You have the same settlement options no matter what type of policy you have (i.e., term, straight life, limited payment life, or whatever).
2. b The 10-year renewable term policy is not a cash value policy.
3. b Your beneficiary will receive only the face amount of the policy (plus any interest and/or accumulated dividends, perhaps). The cash value can be received only by the policyholder, if he should surrender his policy while alive (thereby foregoing any future death benefits).
4. d
5. e You can have life insurance proceeds paid in almost any fashion you wish.
6. a They are single premium policies (protection is paid for in advance).
7. d
8. T
9. T You may add up to 16 percent to your annual premium costs if you choose to pay your premiums other than annually. (This rise in cost is due to the extra bookkeeping and administrative costs incurred by the insurance company.)
10. F Only participating policies pay dividends to policyholders.
11. T You are automatically converted to term policy coverage if you discontinue your cash value policy. (Thus, if you want to recoup your policy's cash value, cancel the policy before it lapses.)
12. F Since your needs are continually changing, you should review your program at least every five years and make adjustments where appropriate.
13. e Choice "a" reduces your cash outlay for the same policy face value, while choices "b," "c," and "d" reduce the face value of the life insurance you need to purchase.
14. a You can adjust your level of coverage annually without the need to create a new policy. Because you are paying for pure insurance, not insurance plus an investment buildup, annual renewable is the least expensive in the year in which the policy is purchased. Since your needs for insurance decrease over the years, even though the cost per \$1,000 of coverage will rise, your cost over time should not be any higher than the cost of the premium at the time it is purchased.

Essay Answers

1. If you choose the lump-sum settlement option and invest the proceeds at a real return above inflation, you need less money to meet your survivor-

ship income needs. For example, if your survivor has a life expectancy of 50 years and needs \$10,000 a year and you therefore figure he or she needs \$500,000 of insurance ($50 \times \$10,000$), you've neglected the "time value" of money. For \$310,000 invested at 4 percent after inflation will provide the \$500,000 your survivor will spend over a 50-year life expectancy.

2. If you purchase insurance to pay estate taxes, you're "actuarially gambling." If you die within 60 percent or so of the number of years you're expected to live, then insurance would be a good investment. If you die after 60 percent of your life expectancy, or when the insurance actuaries think you will, then you are better off to have invested each year the money you would otherwise have spent in premiums.
3. Life insurance needs decrease over time for the following reasons:
 1. Each year you live is one less year you have to worry about providing survivorship income.
 2. Your assets tend to grow over time, thereby making you more able to self-insure.
 3. Children move away from home, eliminating certain need categories entirely.

11-Step Procedure for Determining Your Life Insurance Needs (From first and second editions of the text; may be reproduced for classroom use.)

APPENDIX MATERIAL

1. Eight-Step Procedure (blank form from text Figure 9-1)
2. Shopping for Life Insurance (text Figure 9-10)

TRANSPARENCY MASTERS

These forms have also been reproduced in the *Study Guide*.

APPENDIX 11-Step Procedure for Determining Your Life Insurance Needs

To compute your life insurance needs, use the following 11-step procedure (Fig. 9A-1). With this procedure, you can determine your family's financial needs after your death and the sources of income to meet those needs. You can then plan to use insurance to make up the difference between these two.

1. *Funeral, Administrative, and Estate Tax Expenses.* Estimate these expenses on the basis of your gross estate (net worth plus existing life insurance proceeds). If your gross estate is below \$20,000, you can estimate your funeral, administrative, and estate tax expenses to be \$2,200. If your gross estate is between \$20,000 and \$40,000, use a \$4,400 estimate. If it is over \$40,000 estimate \$6,600.
2. *Debt Resolution.* Determine the amount of money in debts to be paid off at your death. Look at the current debts (liabilities) on your balance sheet. All of these debts (with one possible exception) should be resolved at your death so that your family does not have to worry about maintaining credit relationships. The home mortgage can be considered a separate debt and handled differently. You can either buy a mortgage term policy to pay off this debt if you die or include the annual mortgage payment in an assessment of your family's annual living expense needs (step 5).
3. *Contingency Fund.* Estimate the amount of money your family will need for immediate daily use if you die. With all the other worries they will have upon your death, you do not want them immediately to have to worry about money. Also, you probably cannot predict all the expenses that might surround your death. Normally a contingency fund equal to twice your current monthly take-home pay is sufficient to tide the family over until they have adjusted to your absence.
4. *College Education Fund.* Estimate how much it will cost to send your children to college. By this method, a lump sum covering all four years is planned to be available when the child first starts college. Of course, what is not needed each of the first three years may be invested to keep pace with the rising cost of education.

State-supported colleges cost approximately \$3,250 a year for tuition, room and board, and books. Private colleges average \$5,200 a year. Table 9A-1 estimates the probable annual cost of education 5, 10, 15, and 20 years from now for both private and state-supported schools, assuming these costs grow at 5 percent a year.

TABLE 9A-1
ANNUAL COST OF UNDERGRADUATE EDUCATION

School	Now	Years from Now			
		5	10	15	20
State-supported	\$3,250	\$4,000	\$5,250	\$ 6,500	\$ 8,300
Private	5,200	6,400	8,400	10,400	13,300

Note: From the first and second editions of the text; may be reproduced for classroom use.

Name(s) _____				
Date _____				
ELEVEN-STEP PROCEDURE				
1	<i>Funeral, Administrative, and Estate Tax Expenses</i>	_____	_____	_____
2	<i>Debt Resolution</i>	_____	_____	_____
3	<i>Contingency Fund</i>	_____	_____	_____
4	<i>College Education Fund</i>	_____	_____	_____
5	<i>Annual Living Expenses (by period)</i>	_____	_____	_____
6	<i>Annual Sources of Income (by period)</i>	_____	_____	_____
7	<i>Net Annual Income Needs (by period)</i>	_____	_____	_____
	<i>Number of Years in Period</i>	_____	_____	_____
	<i>Total Net Income Needs (by period)</i>	=====	=====	=====
	<i>Total Net Income Needs</i>	=====	=====	=====
8	<i>TOTAL DISCOUNTED INCOME NEEDS</i>	=====	=====	=====
	<i>Discount Factor (by period)</i>	_____	_____	_____
	<i>Discounted Income Needs (by period)</i>	_____	_____	_____
9	<i>TOTAL MONETARY NEEDS</i>	=====	=====	=====
10	<i>TOTAL INVESTMENT ASSETS</i>	=====	=====	=====
11	<i>Your Life Insurance Needs</i>	_____	_____	_____

Fig. 9A-1. Form to use for determining one's life insurance needs.

If you have other goals that would not change because of the death of your family's breadwinner, you will have to allow for their expense in a similar way.

5. *Annual Living Expenses.* Estimate the amount of money your family will need for the various periods in your family's life cycle. Consider both whether your spouse will work after your death and the length of time between now and when your children will be on their own. Your family's income needs will probably change, as text Figure 9-2 demonstrates. Ignore for now the effect of inflation.
6. *Annual Sources of Income.* Estimate income your family will receive from Social Security (text pp. 546-49), corporate pension or profit sharing plans, and surviving spouse's income.
7. *Net Annual Income Needs.* Subtract the income (step 6) from the expenses (step 5) to get a net annual need for each period in your family's projected life cycle. Multiply the net annual need by the number of years in each period. To determine the length of the period ending in the death of the surviving spouse, look at Table 9A-2. For example, a female age 22 can expect to live to age 79. Add five years to the figure you find in Table 9A-2 and use this number as the final period.

TABLE 9A-2
AVERAGE FUTURE LIFETIME IN UNITED STATES

Age Interval	Average Remaining Lifetime	
	Male	Female
0-1	67.8	75.1
1-5	68.3	75.3
5-10	64.6	71.5
10-15	59.7	66.7
15-20	54.9	61.7
20-25	50.2	56.9
25-30	45.7	52.1
30-35	41.0	47.2
35-40	36.4	42.5
40-45	31.8	37.8
45-50	27.4	33.2
50-55	23.3	28.7
55-60	19.5	24.5
60-65	16.1	20.4
65-70	13.0	16.5
70-75	10.4	13.0
75-80	8.2	9.9
80-85	6.2	7.1
85 and over	4.5	4.8

Source: National Center for Health Statistics, U.S. Dept. of Health, Education, and Welfare, 1967.

8. *Total Discounted Income Needs.* Determine the after-tax-and-inflation yield you feel is achievable, and then determine the discount factors (Table 9A-3) to apply to each period's net income needs. Multiply these

TABLE 9A-3
DISCOUNT FACTORS FOR TWO TYPES OF INVESTMENTS

Years	Discount Factors	
	Savings Account ^a 1% rate of growth (5%-4%)	Securities and Real Estate 3% rate of growth (7%-4%)
5	4.8	4.6
10	9.5	8.5
15	14.0	11.9
20	18.0	14.9
25	22.0	17.4
30	25.8	19.6
35	29.4	21.5
40	32.8	23.1
45	36.1	24.5
50	39.2	25.7
55	42.1	26.7
60	43.9	27.5
65	45.5	28.2

^aHigher returns on savings are available, but for simplicity we are using only 5 percent.

factors by the net annual income needs for the various periods to arrive at the discounted need for each period. Then total these discounted needs. Since your family will not have to use all of the money represented by their total net income needs during the first day, month, or year after you die, much of the money can be invested and withdrawn in increments as needed. The more money your investments earn, the more money can be used to meet your family's needs. Therefore, the amount of money your family really requires is equal to the amount of money that, when invested at a certain yield, will supply the amount of income your family needs over your spouse's expected life span and while your children are dependents.

Suppose you determine that your family needs an average of \$5,000 a year for 30 years—a net income need (step 7) of \$150,000. If your family invested the proceeds from a life insurance policy in a 5 percent passbook savings account and allowed 4 percent of that yield to cover increased prices due to inflation and taxes, all your family would need would be \$129,000 in proceeds. In other words, this \$129,000 invested at 5 percent would provide \$150,000 over the 30-year period, counting both interest income and principal withdrawals. (Compound interest is explained in text Chapter 16, as are the various investments you might select for this purpose.)

Table 9A-3 presents discount factors for two types of investments: savings, and securities and real estate. These factors are already adjusted to allot 4 percent of the investment yield to cover inflation and taxes. If the first period of need is 20 years, the discount factor for a 1 percent rate of growth would be 18. For the next 20-year period the discount factor would be 14.8, the difference between the factor for 20 years (18) and the factor for 40 years (32.8). The factor for the next 10

years after that would be 6.4, the difference between the discount factor for 40 years (32.8) and the factor for 50 years (39.2). The discount factors for securities and real estate are related in the same way.

9. *Total Monetary Needs.* Add the results from steps 1, 2, 3, 4, and 8 to determine your family's total monetary needs.
10. *Total Investment Assets.* Determine what investment assets may be used to help alleviate your family's needs. These assets include all monetary assets and investment real estate, as shown on your balance sheet.
11. *Your Life Insurance Needs.* Subtract your family's monetary assets (step 10) from your family's total monetary needs (step 9). The result indicates the amount of insurance you should own.

10 · Federal Income Taxes on Individuals

After studying this chapter, the students should be able to:

OBJECTIVES

- Describe in general how an individual's federal income tax is computed using gross income, deductions, exemptions, and credits.
- Explain how withholding and the estimated tax procedure work and why they are needed.
- Explain the difference between a progressive tax and a regressive tax and how inflation increases the burden imposed by a progressive tax.
- Define *marginal tax rate* and explain how it can be used in making financial decisions, particularly those involving capital gains.
- Describe the legal methods of reducing one's income taxes—income averaging, income splitting, and tax shelters—and the difficulties in profiting from the latter method.
- Describe the various alternatives for preparation of one's tax return.
- Describe what a taxpayer should do if audited.
- Describe the Social Security taxes and how they are assessed.

As an introduction to the income tax lecture we suggest that you make your students aware of the great impact taxes have on financial decisions. There are few, if any, such decisions that do not involve tax considerations. Point out to your students some of the ways these considerations should affect their financial decisions.

SUGGESTED APPROACH

In order to be able to realize what the tax consequences of various financial decisions might be, your students must be familiar with marginal tax rates and how they are used in the decision-making process. We have found it helpful to run through in class a couple of examples of how to determine marginal tax rates and use them to advantage. (The first two chapter questions in the text treat this subject.)

We suggest that once your students understand how marginal tax rates work, you discuss the distinction between tax planning and tax preparation. Tax planning involves utilizing legally available means of reducing taxable income (e.g., income averaging, income splitting, investing in depreciable real estate, and taking long-term versus short-term capital gains). To be certain that your students understand the concept of tax planning, you might go over in class the example cited in the text or construct examples of your own to use in class discussion. Point out to them that, as they continue with this course, they will learn about other methods of tax planning (the use of

interest and depreciation deductions in real estate investments, Keogh pension plan, investing in tax-free municipal bonds, and the like) and that they should be on the lookout for them.

Tax preparation is concerned with computing and filing correct tax returns. We suggest that in your treatment of this topic you use the Chuck and Nancy case study for Chapter 10. If your students can successfully complete this case problem, they should be prepared to file a simple tax return when the time comes. We have found an effective treatment of tax preparation to be a combination of explaining the elements of an individual's income tax return and actually computing them as they are represented by the Anderson's tax preparation. Note that in the *Study Guide* students are given a blank Form 1040 and blank Schedule A as well as Tax Table A (all for 1978).

To give your students a good picture of the entire process, you might want to put the following outline on the blackboard when you cover this topic:

Begin with	Gross income
Subtract	Deductions against gross income
To arrive at	Adjusted gross income
Subtract	Zero bracket amount and any excess itemized deductions against gross income
To arrive at	Income before exemptions
Subtract	Exemptions
To arrive at	Taxable income

Here is the way we have incorporated the Chuck and Nancy case problem into our presentation of how to file a return. Our material is based on the tax law as it stood in early 1980. Subsequent changes will appear in IRS Publication 17, available at Post Offices (between January 1 and April 15) or from the Government Printing Office (at any time).

- *Gross income* includes all sources of income except those items specifically excluded by law. (See pages 210-11 in the text.)

Chuck and Nancy have a gross income that includes their combined salaries (\$33,000), interest (\$20), and dividends (\$310 less exclusions of \$100 each for Chuck and Nancy); it excludes \$675 in health insurance settlement proceeds. (This amount exactly covered the expenses Chuck incurred for an illness early in the year; the event represented neither an increase nor a decrease in taxable or spendable income for the Andersons.)

- *Deductions against gross income* include ordinary and necessary expenses incurred in following a trade or owning a business (salaries, office supplies, advertising, and so on), expenses resulting from production of rent or royalty income, and expenses required of an employee but not reimbursed by his or her employer (e.g., moving expenses due to job transfer, travel required by one's company with the exception of commuting costs). Technically, losses from the sale or exchange of capital assets are also deductions of this type although they are usually accounted for on Schedule D, and the total from Schedule D is listed on Form 1040.

Chuck and Nancy have deductions of \$125 in nonreimbursed auto expenses (required by employer) and \$550 (50 percent of a long-term capital loss of \$1,100) for a total of \$675. (Because the Andersons have only one capital loss figure to enter, we have omitted the use of Schedule D in this problem.)

- *Adjusted gross income* is income derived before calculating the second set of deductions.

Chuck and Nancy's adjusted gross income is \$32,455.

- *Deductions against adjusted gross income* may be taken to the extent that they *exceed* the zero bracket amount (\$3,400).

Chuck and Nancy have the following itemized deductions:

Charitable contributions	\$ 130
Magazine subscription (<i>Widget Salesman</i>)	5
Employee tools (briefcase)	55
Health insurance premiums	150
Interest on furniture loan	182
Interest on car loan	445
Interest on home mortgage	2,540
Interest on margin loan	55
Property taxes	1,100
Sales taxes (from IRS tax booklet table)	253
Personal property taxes (\$100 for two auto licenses less \$11 for each license)	78
State income taxes actually paid or withheld during the taxable year	1,275
Total	\$6,268

Their excess itemized deductions against adjusted gross income total \$2,868 (\$6,268 - \$3,400). Two of these itemized deductions deserve special mention.

1. The health insurance premium deduction is one-half of the total of health insurance premiums up to a maximum of \$150.
Chuck and Nancy's deduction is \$150; one-half (\$240) of their \$481 health insurance premium is \$90 greater than the \$150 allowed.
2. The medical and dental expense deduction includes (1) medicines to the extent that their cost exceeds 1 percent of adjusted gross income, (2) doctor and dentist expenses, and (3) that portion of health insurance premiums not allowed as a health insurance deduction to the extent that the total of these three exceeds 3 percent of adjusted gross income.

The Andersons' expenses for medicines did not exceed 1 percent of adjusted gross income, and so they do not add anything for medicine to their medical and dental total. They do include \$250 in dental expenses, \$194 in doctor expenses, and the \$331 (\$481 - \$150) in health insurance that was not allowed in their health insurance deduction. This gives them a total of \$775, which is not in excess of \$974 (3 percent of their adjusted

gross income). Therefore, the Andersons can claim no medical and dental expenses deduction other than the \$150 health insurance deduction.

- *Income before exemptions* consists of adjusted gross income less deductions against adjusted gross income.

Chuck and Nancy have \$26,187 income before exemptions (\$32,455 - \$3,400 zero bracket amount and \$2,868 in excess itemized deductions).

- *Exemptions* are \$1,000 for each member of the family.

Chuck and Nancy's exemptions for the four members of their family total \$4,000.

- *Taxable income* is income before exemptions less the total of allowable exemptions.

Chuck and Nancy's taxable income is \$22,187.

- *Tax due* is computed by using the appropriate Tax Rate Schedule.

Chuck and Nancy's tax is \$3,829. To get this amount, they referred to the 1979 Tax Rate Schedule for married taxpayers filing joint returns.

ADDITIONAL TOPICS FOR DISCUSSION

1. As we saw in Chapter 1, inflation can happen when the government creates money at a rate faster than economic growth requires—often to fund government deficit spending. Then people's tax burdens go up because of inflation, but not enough to cover the deficit spending and eliminate the need to create excess money. So the cycle of inflation goes on.

As people's after-tax purchasing power declines, even if their taxable income rises with inflation, they tend to want either to shift the tax burden to someone else or to reduce it via tax shelters. Neither approach can provide a long-term solution. If taxed too heavily, both the rich and corporations find the after-tax return on investment too low to warrant taking on the economic risks entailed in investments that could create jobs and generate more taxable income. Less onerous tax rates for the upper income brackets can, by increasing earned income and encouraging investment, increase the aggregate tax dollars collected, as happened in the early 1960s. One hopes that Congress's belated recognition of this relationship in 1978, when long-term capital gains tax rates were lowered, will produce the same effect.

We cannot emphasize enough the misinformation that exists about tax shelters. The great majority of people who use them merely defer taxes into the future rather than permanently avoiding them. Also, their underlying economics are often shaky. We suspect this is so because investors respond emotionally to the tax shelter attraction of such investments and, as a consequence, do not demand a better economic return from the shelter's sponsors. Needless to say, many tax shelter sponsors profit handsomely from such activities.

2. For people who make more than the Social Security taxable limit of \$22,000 a year, in the early part of the year their take-home pay will be

lower than at the end of the year. Once the Social Security taxes have been paid for the year, their take-home pay jumps, much as if they'd gotten a raise in salary.

Suppose you are in this situation but have a need for more income in the early part of the year than in the later part of the year. You can level out your income by underwithholding on your income tax in the early part of the year and overwithholding once the Social Security tax ceases. To do that, instead of notifying your employer of the number of exemptions you're entitled to, you figure your tax fairly closely and put down the amount (expressed as a percentage or as a specific dollar amount) of tax you want to have withheld. For example, at the early part of the year you might have 10 percent withheld and at the last part of the year change it to 15 percent.

This technique can also help people who have irregular or fluctuating incomes. They can express their taxes as a percentage of their gross income rather than having a very high percentage taken out from high pay and a very low percentage taken out from low pay, which is the way the IRS tax tables work for withholding. You don't have to go by the tax tables. Of course, if you underwithhold your taxes, you may be subject to underpayment penalties (see text).

1. Invite your local U.S. senator or representative or state representative to speak to your class on the formulation of tax legislation at the federal or state level. Someone who serves on congressional or state committees that deal particularly with tax legislation may be able to offer insights into the political and lobbyist aspect of making up tax bills.
2. Invite a tax attorney or CPA to speak on his or her professional practice. You might ask this individual to focus on what, if any, efforts their professional associations (e.g., the ABA) are making to encourage Congress or the state legislature to simplify the tax laws.

GUEST LECTURE IDEAS

Many medical and dental practitioners seek to avoid paying the high income taxes dictated by their often high incomes. Robert Karver, M.D., was no exception. In 1979 he invested \$40,000 with a group of local colleagues in a tax shelter scheme offered by an out-of-state promoter who promised \$2 of tax deduction for each \$1 invested. In Dr. Karver's case, this would be \$80,000. The scheme involved buying an old freighter (of Liberian registry with a Panamanian crew), quickly renovating it, and taking rich Texans on luxury cruises from Galveston to Cozumel.

Dr. Karver never got his tax deduction. In his eagerness to become an international wheeler-dealer he failed to (1) check the promoter's credentials and (2) get the proper documentation to support his tax deduction. The IRS disallowed any deduction on this venture. His \$40,000 is apparently lining some clever, though criminal, promoter's pocket somewhere.

SAMPLE CASE

ADDITIONAL MATERIALS AND ACTIVITIES

The instructor may find it advisable to have a copy of Commerce Clearing House's *Federal Tax Course* (latest edition) available for reference when answering specific questions from students.

Copies of the latest edition of *Your Federal Income Tax*, Publication 17 (Government Printing Office, Washington, D.C.) might be obtained for each class member. If they have this publication, research reports might be assigned to determine requirements for claiming dependents, compute the alternative tax on long-term capital gains, compute the sick pay exclusion, and compute the retirement income credit.

1. Have your students visit the local office of the IRS and ask one of the administrators to explain how income returns are audited and how disputes are resolved on the local level. Also have them ask for literature explaining their legal rights and remedies in tax disputes with the IRS. (This should be done before February 1 or after April 15.)
2. Have your students read the tax column that appears every Wednesday on the front page of the *Wall Street Journal*. If they do this for two months, they should develop a good idea of the tremendous amount of change constantly taking place in the field of income taxation.
3. Have your students visit a session of the Small Case Tax Court if your school is in a large metropolitan area where this court might be in session during one part of the year. (It visits over 60 cities each year.) This will allow them to observe the proceedings and judge for themselves whether or not the average citizen can effectively represent himself.

ANSWERS TO CHAPTER QUESTIONS

1. Taxes will increase by \$168 for the additional \$800 in dividend income.
 $.21 \text{ marginal tax rate} \times \$800 \text{ dividend income} = \$168 \text{ tax increase}$
2. Taxes will be reduced by \$546.
 $.21 \text{ marginal tax rate} \times \$2,600 \text{ deduction} = \$546 \text{ tax saving}$
3. Too much might be paid in Social Security taxes if an individual held two jobs during one year, one before the other, and Social Security taxes were withheld on the income from each job. In such a case it would be possible for withheld Social Security taxes to exceed the maximum that the government requires employers to withhold. Refunds may be obtained by filing Form 843.
4. Five sources of income that can be excluded from gross income for tax purposes are:
 - veterans benefits
 - health insurance settlement proceeds
 - welfare payments
 - gifts
 - income tax refunds(More may be found on pages 210-11 of the text.)

5. Tax planning tries to assess the tax impact of alternative courses of action as they relate to a financial decision. (For example, it would be tax planning to determine that prepaying some of next year's excess itemized deductions in this taxable year will result in a deduction larger than that afforded by not doing so.) Tax preparation encompasses the tasks involved in filing one's tax return each year.
6. Assuming all avenues of recourse and appeal within the IRS itself have been exhausted, in substantive cases (those too large to be heard before the Small Case Tax Court) the best course of action probably would be to engage the services of a tax attorney and take the case before the federal court.

The attorney's responsibility would be to represent the client in subsequent federal court proceedings. The expenses associated with this strategy should be incurred only if they are known in advance and are significantly less than the amount of taxes in dispute or if a defense against fraud charges is involved.

7. To the extent that it is borne by the employer, the effect is reduced profits; by the employee, reduced salary or wages; or by the consumer, increased costs of a service or product.

Student-Oriented Case Problems

1. Yes, the Howards do qualify for income averaging this year.

The procedure is as follows. Take the sum of your taxable income for the previous four years, not including the current year. Multiply this sum by 30 percent (.3). Add \$3,000 to this amount. If your current taxable income is greater than the result, income averaging may be appropriate.

$$\$8,000 + \$12,000 + \$6,000 + \$15,000 = \$41,000$$

$$\$41,000 \times .3 = \$12,300$$

$$\$12,300 + \$3,000 = \$15,300$$

No, because their taxable income for the current year is less than \$15,300.

Each brother's marginal tax rate would be 24 percent.

The total amount of tax that would be paid on the \$10,000 of investment income would be \$2,400.

Each brother would save \$48 if the investment provided \$200 of depreciation deductions for each of them.

2. The students should obtain answers to the following questions: Does the tax preparation service have a system whereby the taxpayer is questioned to make sure no deductions have been overlooked? What response does the service have to the charge that, because the information collecting can be done only by the taxpayer, most tax preparers merely fill out the return? What type of training and certification is required to become a tax preparer?
3. The loss in after-tax purchasing power over the five-year period is \$800 (all due to the progressive nature of our income tax structure).

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

Net after-tax income in year 1 is \$13,700. By year 5, it will cost approximately \$20,300, with inflation of 48 percent for this period, just to support the same lifestyle as could be purchased for \$13,700 in year 1. While before-tax income has increased 50 percent during this period

Chuck and Nancy Anderson Computing Their Income Taxes

Because we have found this particular Chuck and Nancy case problem to be such an excellent vehicle for teaching our students how to compute their income taxes, we have incorporated our suggestions as to how to apply Chuck and Nancy for this chapter into the suggested approach. The following are the answers to the questions at the end of the case problem.

1. The item that should not be included is \$675 in health insurance settlement proceeds. (It would also be acceptable if your students excluded the \$200 exemption on dividends in their answer.)
2. The Andersons' dividends were \$310. From this, the \$100 allowable exclusion per person is deducted. Chuck and Nancy deduct \$100 apiece because they are filing a joint return. They add the remaining \$110 to their gross income.
3. The two deductions against gross income on the Andersons' list are \$125 in nonreimbursed auto expenses required by Chuck's employer and \$550 representing one-half of their \$1,100 long-term capital loss on the sale of their stock.
4. \$550 (one-half of their capital loss) can be offset against their gross income.
5. The current zero bracket amount allowed by the IRS for married taxpayers filing joint returns is \$3,400.
6. The current exemption level per person allowed by the IRS is \$1,000. The Andersons' total exemptions would be \$4,000.
7. No. Medicines may be included in the medical and dental category for deductions against adjusted gross income only to the extent that they exceed 1 percent of adjusted gross income. The Andersons' medicines cost them \$25 while 1 percent of their adjusted gross income is \$324.55.
8. One-half of the Andersons' medical insurance premiums (up to a dollar maximum of \$150) may be used as a deduction against adjusted gross income. For the Andersons this deduction amounts to \$150, the maximum dollar amount allowable of their \$481 premium. The remaining \$331 of the health insurance premiums is added to the \$250 in dental expenses and to the \$194 in doctor expenses, for a total of \$775. The portion of this amount that exceeds 3 percent of the Andersons' adjusted gross income is used as a medical and dental deduction. Three percent of \$324.55 is approximately \$974, and so the Andersons can claim no medical and dental deduction.

9. The Andersons' taxable income is \$22,187.

Gross income		\$33,130
Salaries	\$33,000	
Interest	20	
Dividends	110	
Deductions against gross income		675
Nonreimbursed auto expenses	125	
One-half of capital loss	550	
Adjusted gross income		32,455
Zero bracket amount		3,400
Excess itemized deductions against adjusted gross income		2,868
Charitable contributions	\$ 130	
Magazine subscription (<i>Widget Salesman</i>)	5	
Employee tools (briefcase)	55	
Health insurance premiums	150	
Interest on furniture loan	182	
Interest on car loan	445	
Interest on home mortgage	2,540	
Interest on margin loan	55	
Property taxes	1,100	
Sales taxes (from IRS table)	253	
Personal property taxes (\$100 for two auto licenses less \$11 for each license)	78	
State income taxes actually paid or withheld during the taxable year	1,275	
Income before exemptions		\$26,187
Exemptions		4,000
Taxable income		22,187

**SAMPLE TEST
QUESTIONS**

Objective Questions

Circle the letter of the correct answer to each question.

1. Which of the following individuals have the election of filing a joint return?
 - a. Husbands and wives
 - b. Brothers and sisters
 - c. Twins
 - d. (None of the above)
2. You will be required to file a declaration of estimated income tax if
 - a. you expect your total tax to be \$100 or more than the amount withheld during the year
 - b. you are single with an income in excess of \$20,000 which is subject to withholding
 - c. your previous year's tax was computed using income averaging
 - d. you expect to receive over \$500 in income not subject to withholding
 - e. both "a" and "c"
 - f. both "a" and "d"
 - g. "a," "b," and "d"
3. For which of the following would you be allowed additional exemptions?
 - a. Blindness
 - b. Loss of an arm
 - c. Insanity
 - d. (None of the above)
4. Heads-of-household enjoy a tax advantage over other single individuals as reflected in tax rate tables.

True False
5. All sources of income must be included in gross income for tax purposes.

True False
6. Deductions and exemptions are the same thing.

True False
7. Income averaging is appropriate only for those taxpayers whose adjusted gross incomes are consistently in excess of \$20,000.

True False
8. Which of the following should you expect from a tax consulting service?
 - a. Double-check computations for correctness
 - b. Represent you in all legal disputes with IRS
 - c. Prepare your return in quadruplicate
 - d. Help you write a will

Essay Questions

1. Give reasons why our federal income tax laws have become so complex.
2. What qualities should you look for in a professional tax preparer?
3. What effect does inflation have on taxpayers' burdens?

**ANSWERS TO
SAMPLE TEST
QUESTIONS**

Objective Answers

1. a Only married individuals may file joint returns.
2. g If any of the three conditions cited exists, Form 1040ES must be filed.
3. a Additional exemptions are available for taxpayers who are blind at the end of the taxable year.
4. T There are lower rates for heads-of-household to give tax relief to single individuals with family responsibilities.
5. F Certain sources of income are excludable from gross income. (See pages 210-11 in the text for a partial list of excludable items.)
6. F Deductions and exemptions are treated differently for tax purposes.
7. F Income averaging is appropriate for individuals whose income changes significantly from year to year.
8. a

Essay Answers

1. Our federal income tax laws are complex because this area of government activity is not used exclusively to raise revenues to cover federal government expenditures. The government also uses income taxation as a means of redistributing wealth from the economically fortunate to the unfortunate and encouraging certain types of economic activities such as home ownership.
2. The first quality you should look for is technical expertise that is appropriate for your needs. For example, CPAs and tax attorneys generally should be consulted only on complex and sophisticated tax questions; public accountants should be used for small businesses and individuals with fairly simple tax accounting needs; national and local tax services are probably best suited for returns where the sources of income are simple but deductions are itemized. In addition, the preparer must be willing to sign the return, give you a copy of it, allow you to proof his or her work, compute your taxes by every available method, and insure the accuracy of the computations on the return.
3. Inflation tends to drive people's taxable incomes into higher tax brackets. When an individual's income rises primarily because of inflation, it does not result in any real increase in purchasing power, but the taxpayer nevertheless has to pay a greater percentage of income in taxes.

11 · Borrowing and Banking

After studying this chapter, the students should be able to:

OBJECTIVES

- Explain how borrowing works in principle, including the concept of amortization.
- Discuss the guidelines for using debt properly.
- Compute the effective cost of borrowing.
- Determine the dollar drain caused by borrowing, taking into consideration the effect of taxes and inflation.
- Describe the consumer protection offered by truth in lending.
- Explain how to shop for a loan.
- List and describe the advantages and disadvantages of the various sources of consumer loans.
- Describe the sources of education loans.
- Use the rule of 78 to calculate the rebate of finance charges on the pre-paid balance of a loan.
- Describe the considerations involved in declaring bankruptcy.
- Describe how a checking system works.
- Describe how to balance a checkbook and avoid overdrafts.
- Explain the considerations in choosing a checking account and a bank.

We recommend opening the class discussion with a discussion of the validity of arguments used both for and against borrowing. The purposes of this discussion should be:

SUGGESTED APPROACH

1. To elicit the reasons why your students are for or against borrowing
2. To help your students distinguish between financial reasons (i.e., borrowing can lead to bankruptcy; borrowing increases one's purchasing power) as opposed to emotional reasons (i.e., the ability to borrow is a status symbol; using someone else's money is bad)
3. To help your students realize that the most intelligent decisions about the use of borrowed money are based on financial, not emotional, reasons

The second stage of class treatment of borrowing should revolve around the issues of how much to borrow and for what. As we state in the text, there is no one formula that can be used to answer the question of how much to borrow. Assuming that one deals only with responsible lending sources,

at any given time one's debt limit will be dictated by two opposing forces: need and repayment ability. Need is a factor of the size of one's income and/or position in the family life cycle. For example, as a young adult with parental financial support, one's need to borrow would probably be limited to education expenses. Once married, the costs of developing a family and the relatively low level of earnings of a neophyte breadwinner combine to make one's needs great. With time, one's needs decrease because of increased income and financial assets—a home, bank accounts, and the like; eventually one's children become self-supporting adults. The second force, repayment ability, will be the primary concern of the prospective lender; he will not lend money he does not expect to be repaid. The opposition between these two forces, then, lies in the fact that what the would-be borrower thinks he needs is not necessarily what he will get. In the end, that decision is made by the lender.

The answer to the question of what money should be borrowed for is a matter of opinion. Ours is that borrowing should be used sparingly and only to finance assets. These may be tangibles (i.e., a home) or intangibles (i.e., a college education). Never should one borrow money for consumables—food, clothes, vacations, and the like. A person who is unable to provide for these items out of income is not budgeting his or her income and expenses properly.

Computational Aspects of Borrowing

We recommend that you use the Chuck and Nancy case problem for this chapter leading into a discussion of borrowing costs. If you assign the case problem as homework and then go over the answers to the questions with your class, your students should begin to feel comfortable dealing with the computational aspects of borrowing. The answers to the questions for Chuck and Nancy are in the case problem section of this chapter. All of the information your students will need in order to answer the questions is included in the statement of the problem itself.

The idea around which this case problem has been developed is that it is extremely important to determine, every time one considers borrowing, whether or not having an item right now is worth the total amount that must be paid in finance charges on a loan plus the amount of interest lost on a savings account. The dollar cost of Chuck and Nancy's immediate enjoyment of their new car is \$990 and the answer as to whether they were wise to borrow for it will vary according to circumstances. For example, if their old car ran on only three cylinders (out of eight) it may have been worth the \$990 for the Andersons to provide themselves with a more reliable car. On the contrary, if the old car was merely old and not breaking down, then maybe the \$990 should have been used another way—perhaps they should have waited to pay cash for the new car and used the \$990 saved on finance charges to pay for something else (e.g., a vacation or new household appliances).

Once the instructor has completed discussing Chuck and Nancy, it is time to introduce the procedure of measuring the effect of inflation and income taxes on the cost of borrowing. Here we recommend that you use examples based on annual payment periods. Examples with monthly payment periods can be very frustrating to your students because of the difficulty in separat-

ing each monthly payment into interest and principal. The procedure and its effects are the same, although the total interest costs on monthly amortized loans will always be less because the principal begins to be drawn down sooner than that of yearly amortized loans (at the end of the first month as opposed to the end of the first year).

A discussion of Table 11-3, which concerns the effect of inflation and tax savings on a \$3,000 loan (page 247 in the text), would be valuable here. Two points should be stressed to the students:

1. The actual amount of taxes saved is determined by multiplying the marginal tax rate by the interest on the loan. (Be certain that your students understand that the marginal tax rate is multiplied by *only the interest*.) Interest paid on a loan is a deduction against adjusted gross income and will result in a tax savings only if the taxpayer has enough excess itemized deductions (over the zero bracket amount) to make it worth itemizing them.
2. The reduced purchasing power of the dollars being paid back to the lender represents the entire annual payment. Point out to your students that the inflationary effect is cumulative. For example, at the end of the first year, the dollars paid back are roughly 5 percent less valuable than those borrowed. At the end of the second year, the dollars paid back are 10 percent less valuable than those borrowed.

Next, the process of shopping for a loan and the various sources from which loans may be obtained should be covered. Class discussion can parallel these treatments in the text. In addition, the instructor may want to ask for personal experiences of class members or make use of some of the additional activities suggested for this chapter.

Other Banking Services

Class attention should be turned particularly to the material on types of checking accounts and how to keep a checkbook balanced. With regard to types of accounts, do not assume that the information in the text is absolutely accurate for two reasons. First, types of checking accounts vary somewhat by geographic region. Second, this is currently one of the most competitive areas of commercial banking. Therefore, what is and is not available is changing rapidly. We suggest that you or your class canvass the local banking community to be sure of the facts that are up-to-date and pertinent to your area. In determining the costs of various accounts, do not overlook potential charges for being under a specified minimum balance, bounced checks, stop-payment orders, new checks, and the like.

We strongly recommend you spend time going through the exercise of balancing a checkbook. Blank copies of the checkbook ledger, bank statement, and statement reconciliation forms are provided in the *Study Guide* and also in the transparency masters at the end of this guide. You might use these forms to work through the third case problem in the text. To make the situation seem more real, the Flanders' running balance is shown in Figure 11-A, and their bank statement is shown in Figure 11-B. You might copy these for the students; however, you may want to give them out only after

the students have answered the case problem questions, as Figure 11-A does make the answers to case problem questions a and b more readily apparent than does just the text information. Also, Figure 11-B shows that the Flanders were charged for only one overdraft because checks 1005 through 1008 were not cashed during the statement period; this information could confuse a student in answering the first three questions with the case problem. Figure 11-C shows how the Flanders might balance their checkbook, based on the information in Figures 11-A and 11-B. The difference between the checkbook balance of -\$393.55 and the reconciliation balance of -\$397.55 is the \$4 overdraft charge.

- SAMPLE CASES** 1. One of the most common mistakes that people make when determining how much to borrow is to assume that their income will continue at its current level or increase. This is not always the case. Lou Henningson was working as the assistant sales manager for a large stereo components retailer in Los Angeles when he was recruited to be sales manager for a competitor in Portland. When he and Dorothy arrived in Portland, they went on a buying spree because housing costs and other living costs were

RECORD ALL CHARGES OR CREDITS THAT AFFECT YOUR ACCOUNT									
NUMBER	DATE	DESCRIPTION OF TRANSACTION	PAYMENT/DEBIT		✓	FEE (AMT)	DEPOSIT/CREDIT		BALANCE
			1-1	T		1-1	(*)		
A	4/12	Opening deposit					900	-	900 -
1001	4/12	Ace Hardware	12	72					887 28
1002	4/20	Northern Savings Home mortgage	777	43					109 85
B	4/20	Bi-weekly payroll					347	50	457 35
1003	4/21	ABZ Finance Company Auto payment	432	12					25 23
1004	5/3	Harlands Grocery Monthly food	112	10					(86 87)
C	5/5	Transfer from savings					400	-	313 13
1005	5/6	Bess Clothing Shoppe	342	15					(29 02)
1006	5/6	John's Sports Store	9	67					(38 69)
B	5/8	Bi-weekly payroll					347	50	308 81
1007	5/9	Unlimited Travel Inc.	287	30					21 51
1008	5/12	Mt. Carmel Junior College	415	06					(393 55)

Fig. 11-A. The Flanders' checkbook ledger showing their running balance.

DATE OF PREVIOUS STATEMENT		DATE OF THIS STATEMENT	
04/18/80		05/18/80	
ACCOUNT NUMBER			
01-01901-8			
DISPOSITION CODE	NUMBER OF ENCLOSURES	PAGE NO.	
M		1	

CHECKING ACCOUNT ACTIVITY (SEE REVERSE SIDE OF STATEMENT FOR IMPORTANT INFORMATION)

CHECKS AND OTHER DEBITS		DEPOSITS AND OTHER CREDITS		LOW BALANCE	AVERAGE BALANCE	SERVICE CHARGE	BEGINNING BALANCE		
NO	AMOUNT	NO	AMOUNT						
04	1 33437	03	1 64750	-96.87	410.68	4.00		000.00	
TRANSACTION DESCRIPTION		AMOUNT	DATE	TRANSACTION DESCRIPTION		AMOUNT	DATE	RUNNING BALANCE	DATE
Deposit A		900.00	4 12					900.00	4 12
Check 1001		12.72	4 14					887.50	4 14
Check 1002		777.43	4 21					109.85	4 21
Deposit B		347.50	4 21					457.35	4 21
Check 1003		432.12	4 23					25.23	4 23
Check 1004		112.10	5 04					-86.87	5 04
Service ch		4.00	5 04	OD				-90.87	5 04
Deposit C		400.00	5 05					309.13	5 05
Deposit D		347.50	5 09					656.63	5 09
								656.63	5 09
							ENDING BALANCE		

Fig. 11-B. The Flanders' bank statement.

CHECKS OUTSTANDING			
CHECK NUMBER		AMOUNT	
1005	Bais Clothing	342	15
1006	Johns Sports	9	67
1007	Unlimited Travel	287	30
1008	Mrs. Caroline	415	06
TOTAL		ENTER IN THE SPACE PROVIDED ABOVE	
		\$1,054 18	

STATEMENT BALANCE		\$ 656	63
ADD	DEPOSITS MADE BUT NOT SHOWN ON THIS STATEMENT	-0-	
TOTAL		\$ 656	63
SUBTRACT	CHECKS OUTSTANDING	1,054	18
TOTAL	SHOULD AGREE WITH YOUR CHECK BOOK BALANCE	(\$ 397 55)	

Fig. 11-C. The Flanders' statement reconciliation.

lower there than in L.A., Lou's salary had doubled with his increased responsibilities, and Dorothy had found a job as a research assistant in a local investment counseling firm.

Three months after their arrival, the Portland stereo retailer declared bankruptcy. If it had not been for Dorothy's job, the Henningsons would have also had to declare bankruptcy. Fortunately, they were able to exchange their home for a more modest one and over the next two years work their way out of their other debts. Lou reentered the work force after three months of being unemployed. Thereafter, they always lived on one salary and saved the other.

2. Dave wanted to save money, but somehow it always slipped through his fingers—for clothes, entertainment, vacations. He decided he was never going to acquire any assets of consequence unless he forced himself to save. His concept of forcing himself to save money was something he learned from his parents, which was to buy things on time. He realized that he was paying 12 to 14 percent interest to do so, but he reasoned that the interest was tax deductible and it definitely forced him to save money. He was able to buy assets that he probably would have never saved up the cash to buy. Perhaps it is a weak argument, but it is another way of looking at buying assets with borrowed money rather than cash.

GUEST LECTURE IDEAS

1. Have a local lender visit your class and tell how prospective borrowers are evaluated. Ask him or her to show the documents that comprise the loan agreement and explain the lending services offered by the organization.
2. Invite a commercial banker to class to explain how checking systems work on a local and nationwide basis.

ADDITIONAL MATERIALS AND ACTIVITIES

1. Have those members of the class who have education loans discuss how their loans were obtained and the characteristics of their loan programs.
2. Have your students shop for a loan. They should visit at least five different lenders, representing at least three different types of lending organizations. Compare current interest rates and repayment terms in class.
3. Have your students follow the federal funds rate located under "Money Rates" in the *Wall Street Journal's* Financing Business section. (This rate represents the amount banks charge other banks for daily loans from their surplus funds.) Have your students chart the course of this rate daily for two months. This should give them a good indication of the general direction interest rates are taking in the money market.

ANSWERS TO CHAPTER QUESTIONS

1. Borrowing can be morally wrong if the borrower (a) knows he or she may be unable to meet the lender's terms, (b) by borrowing will cause undue hardship on other family members, or (c) has no intention of

making repayment. It is morally right if the borrower knows the payments can and will be made and won't create hardship for anyone else.

Borrowing, if used unwisely, can allow a person to live beyond his or her means (until he or she can no longer keep up with the payments).

Borrowing can lead to financial problems because a borrower who is not careful to stay within a budget can take on more debts than he or she can comfortably repay. (This can lead to a very bad credit rating, to having items repossessed, or—in the extreme—even to bankruptcy.)

Borrowing can be worth the cost and risks if used within the limits of one's budget and if used to purchase assets rather than consumables.

There is no one correct answer to the last part of this question. Whether or not a student is in favor of borrowing is up to the individual; but the reasons given should be financially sound and not based on emotional reactions.

2. The National Defense Education Loan Program loans money to students, while the Guaranteed Student Loan Program only guarantees loans issued by private lending sources. In addition, the National Defense Student Loan Program's payback period is 10 years with repayment beginning after leaving school, and the loans have an interest rate of 3 percent; the Guaranteed Student Loan Program has varying interest rates up to a maximum of 7 percent payable by the former student, and requires that interest on the loan be paid while the student is in school.
3. Commercial banks have the most borrowing opportunities for the borrower with a good credit rating. They offer more extensive services at generally lower rates than any of the other sources. Their services range from unsecured 90-day notes and checking account automatic loans (to cover overdrafts) to long-term installment loans.
4. A secured loan requires some form of collateral or guarantee. An unsecured loan merely requires a promise to pay.
5. Generally, the younger one is in the family life cycle and/or the lower one's income, the greater the need for borrowed funds.
6. Inflation reduces the cost of borrowing because the dollar you pay back is worth less than the dollar you borrowed.
7. When a taxpayer cannot itemize excess deductions against adjusted gross income, there are no tax savings associated with the cost of borrowing.
8. Because of the obligation to make a regular debt payment, a certain amount of money must be set aside each month.
9. The biggest clue is the eagerness to lend money without concern about the borrower's ability to repay under "reasonable" circumstances. High pressure tactics and evasive responses to questions concerning terms of the loan, the lender's background, and so on are also good indications.
10. When shopping for a loan, you should find out:

- the exact amount to be received
 - whether the finance charge is added on or discounted
 - the effective interest rate
 - the repayment schedule
 - whether there are prepayment or late payment penalties
 - the kind and amount of collateral required
11. The three considerations are the cost of the particular checking plan you have selected, the convenience of the commercial bank's branch, and the courteousness of the branch's personnel.
 12. a. The retail store deposits the tourist's check in its local bank.
 - b. The retail store's commercial bank in turn deposits the tourist's check with the regional Federal Reserve bank.
 - c. This FRB sends the tourist's check to the regional FRB nearest the tourist's own commercial bank.
 - d. The second FRB debits the tourist's bank with the amount of the tourist's check.
 - e. The tourist's bank debits the tourist's account for the amount of the souvenir purchase.
 - f. An appropriate credit is made by the second FRB to the first FRB for the check's amount.
 - g. The same procedure is carried out by the first FRB to the retail store's commercial bank and by the retail store's commercial bank to the checking account of the retail store.

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

Student-Oriented Case Problems

1. The first step is to analyze the terms of each prospective loan.
The loan from *commercial bank A* is inappropriate because the \$3,000 borrowed must be repaid in a lump sum plus the interest accrued. Our friend can afford monthly payments of \$125 or less.
Using the formula for determining the dollar drain due to credit buying (page 246 in the text), we find that the monthly payment represented by the terms of *commercial bank B's* loan is \$112.21.

$$\frac{10 \times 3,500 \times 37}{12 \times 200} - \frac{1,295,000}{2,400} = \$539.58 \text{ credit cost}$$

$$\$3,500 + \$539.58 = \$4,039.58 \text{ total cost}$$

$$\frac{\$4,039.58}{36} = \$112.21 \text{ monthly payment}$$

This represents a reasonable monthly payment for our friend, and the interest rate is not excessive.

The terms of the loan offered by the *consumer finance company* are the least attractive of all four. If 18 percent of the \$3,200 is discounted in advance, our friend will walk out of the lender's office with only \$2,048. This is far below the minimum amount he needs.

The \$2,048 is derived as follows, assuming \$800 is paid off each year.

Year	Average Balance Outstanding	Discounted Interest at 18%	Cumulative Interest Paid
1	\$2,800	\$504	\$ 504
2	2,000	360	864
3	1,200	216	1,080
4	400	72	1,152

$$\$3,200 - \$1,152 = \$2,048$$

The monthly payments of \$66.67 ($\$3,200 \div 48$) would be within his budget, but the effective cost of borrowing is very high. Because interest was discounted and therefore deducted in advance, our friend would have the use of only \$2,048 although he would be paying back \$3,200. From the formula for determining the effective cost of borrowing, we can determine that the effective rate is 27.55 percent.

$$\frac{200 \times \$1,152 \times 12}{2,048 \times 49} = \frac{2,764,800}{100,352} = 27.55\%$$

The loan from the *credit union* represents a monthly payment of \$81.92.

$$\frac{9 \times \$4,000 \times 61}{200 \times 12} = \frac{2,196,000}{2,400} = \$915 \text{ credit cost}$$

$$\$915 + \$4,000 = \$4,915 \text{ total cost}$$

$$\frac{\$4,915}{60} = \$81.92 \text{ monthly payment}$$

The issue to be decided here is whether \$4,000 as opposed to \$3,500 is needed and whether our friend is willing to be in debt for five years rather than three years.

2. First, add up the remaining months (9 through 15) in inverse fashion (7 through 1) and divide the sum by 78.

$$7 + 6 + 5 + 4 + 3 + 2 + 1 = 28$$

$$28 \div 78 = 35.9\%$$

The next step is to determine what the total interest cost on the original loan was. This is accomplished as follows:

$$\frac{(12)(\$2,000)(15 + 1)}{(200)(12)} = \frac{\$384,000}{2,400} = \$160$$

Then determine the amount of the monthly payment:

$$\$2,000 \text{ (amount borrowed)} + \$160 \text{ (total interest cost)} = \$2,160$$

$$\$2,160 \div 15 \text{ (monthly payments)} = \$144$$

The amount still owing if the loan is to be paid off immediately is computed as follows:

$$7 \text{ (payments remaining)} \times \$144 \text{ (monthly payment)} = \$1,008$$

$$35.9\% \times \$160 \text{ (total interest cost)} = \$57.44 \text{ (interest cost to be refunded)}$$

$$\$1,008 - \$57.44 = \$950.56$$

3. a. According to their checkbook ledger, the Flanders overdrew their checking account four times.

Note: Figure 11-B shows, however, that they were charged for only one on their monthly statement because checks 1005 through 1008 were not cashed during the statement period.

- b. \$86.87, \$29.02, \$38.69, \$393.55

Note: See Figure 11-A for the mathematical calculations.

- c. $(\$393.55) + 4 \times (4) = (\$409.55)$

- d. They seem to write checks before making deposits.

Note: As Figure 11-B shows, however, this practice has not caught up with them fully during the current month.

Chuck and Nancy Anderson

Computing the Cost of Immediate Enjoyment

1. According to the formula, the total dollar cost the Andersons must bear for paying for their car with a loan is \$4,740.

$$\frac{(12)(\$4,000)(37)}{(200)(12)} = \frac{\$1,776,000}{2,400} = \$740$$

$$\$4,000 + \$740 = \$4,740$$

Note that in the formula, 12 percent is represented as a whole number, not as a decimal.

2. Each monthly payment must be \$131.67 ($\$4,740 \div 36$).
3. They would have had to invest \$1,250 at the end of each year for the three previous years in order to have \$4,000 with which to pay cash for their car last year.

This may seem somewhat unrealistic because one could begin earning interest from the beginning of the year by making monthly deposits. However, the compound interest tables at the back of the text are only broken down into annual investments.

The only effect of using the annual rather than monthly tables now will be that the savings as a result of saving to buy rather than borrowing to buy will be greater in reality than on paper.

4. They would have had to set aside \$104.17 ($\$1,250 \div 12$) each month.
5. This represents a savings of \$27.50 a month over the Andersons' loan repayments.
6. The two ways the Andersons could compute the cost of immediate enjoyment of the car are:

- Multiply the amount they could have saved each month if they had paid cash for their car by the number of payments they have to make on their loan.

$$36 \times \$27.50 = \$990 \text{ cost of immediate enjoyment}$$

- Subtract the amount they would have had to put aside during the three years to pay cash for their car from the total amount they will have to pay on their loan.

$$\$4,740 - (3 \times \$1,250) = \$990 \text{ cost of immediate enjoyment}$$

**SAMPLE TEST
QUESTIONS**

Objective Questions

Circle the letter of the correct answer to each question.

1. Consumer credit and consumer loans represent the same type of borrowing.
True False
2. When a loan is taken out on the cash value of a life insurance policy, the death benefit is reduced by the amount of the loan.
True False
3. Term life insurance policies may be used to obtain consumer loans.
True False
4. Which of the following is NOT a source of consumer loans?
 - a. Brokerage houses
 - b. Savings and loan associations
 - c. Commercial banks
 - d. Pawnbrokers
 - e. (All of the above)
5. People who are not members of a credit union, but know the credit union's loan officer, may borrow from one.
True False
6. An unsecured loan requires no collateral.
True False
7. A pawnbroker does NOT normally accept as security
 - a. a signed promise to pay
 - b. jewelry
 - c. clothes
 - d. furniture
8. A loan shark is a good source of inexpensive consumer loans.
True False
9. Which of the following services do banks NOT offer?
 - a. Installment loans
 - b. Cash-value insurance
 - c. Special payment plans
 - d. Real estate mortgage loans
 - e. (All of the above)
10. Which of the following sources of consumer loans require credit investigations?
 - a. Consumer finance companies
 - b. Pawnbrokers
 - c. Savings and loan associations
 - d. Credit unions

11. Before shopping for a loan, you should always decide how much money you need.

True False

12. Which of the following items is a consideration when comparing various lending sources?

- a. Interest cost
- b. Repayment schedule
- c. Prepayment penalty
- d. Your past experience with certain lenders
- e. (All of the above)

13. Borrowing, when ill-conceived, may jeopardize the soundness of your financial resources.

True False

14. What types of information would a lender expect you to provide him?

- a. Status of your financial resources
- b. Employment record
- c. Credit record
- d. Reasons for seeking a loan
- e. (All of the above)

15. Assume that you could purchase \$2,400 worth of furniture on an installment credit basis for \$107.50 a month for 24 months with no down payment. As an alternative buying method, you could put \$100 a month in a 5 percent savings account, wait two years, and purchase the furniture for cash at an inflation-adjusted price of \$2,544. Assume an average savings account balance of \$600 for the first year and \$1,800 for the second year. What is the cost of immediate enjoyment (the extra dollar cost of buying that furniture today)?

- a. \$36
- b. \$144
- c. \$156
- d. \$300
- e. \$444

16. Richard took out a bank loan for \$6,000 at 14 percent interest, with repayment due at the end of 12 months. During that time inflation rose at 7.5 percent. Richard was in a 30 percent tax bracket and was able to take his interest expense as an excess itemized deduction. What was Richard's true cost of borrowing that money?

- a. -25.5%
- b. 2.3%
- c. 4.5%
- d. 5.6%
- e. 14.9%

17. Amortization means a loan is scheduled to be paid off in one lump sum.

True False

18. Banks cannot indemnify you against losses to the contents of your safe-deposit box.

True

False

Essay Questions

1. Explain the concept of amortization.
2. Explain the effect of income taxes and inflation on the cost of borrowing.
3. What guidelines might you use to set proper debt limits?

Objective Answers

ANSWERS TO SAMPLE TEST QUESTIONS

1. F Consumer loans involve an actual exchange of money while consumer credit involves an exchange of merchandise.
2. T
3. F Term life insurance policies have no cash value on which a loan may be made.
4. a Loans from brokerage houses may be used only for securities transactions.
5. F Only members of credit unions may exercise this privilege.
6. T
7. a Pawnbrokers require personal property as collateral for their loans.
8. F Loan sharks are notorious for charging exorbitant interest rates.
9. b
10. a Pawnbrokers rely on secured personal property; savings and loan associations grant loans only to holders of share or savings accounts that can be used as collateral; and credit unions loan funds only to investor/members of their organization.
11. T
12. e
13. T You should always check to see what impact your proposed loan will have on both your balance sheet and your budget.
14. e
15. c $24 \text{ months} \times \$107.50 \text{ per installment} = \$2,580 \text{ total cost of loan}$
 $\$2,580 - \$2,400 \text{ cost of furniture} = \$180 \text{ interest on loan}$
 $.05 \times \$600 = \$30 \text{ interest lost on savings the first year}$
 $.05 \times \$1,800 = \$90 \text{ interest lost on savings the second year}$
 $\$180 + \$30 + \$90 = \$300 \text{ total cost of borrowing}$
 $\$300 - \$144 \text{ inflation adjustment on the cost of the furniture in 2 years} = \$156 \text{ cost of immediate enjoyment}$
16. b The tax effect is a reduction of 4.2 percent ($14\% \times .3$). The inflation effect is a reduction of 7.5 percent. The total reduction is 11.7 percent. $14\% \text{ interest} - 11.7\% \text{ total reduction} = 2.3\% \text{ after-tax-and-inflation cost of borrowing}$
17. F Amortization means a loan is scheduled to be paid off in a series of payments over some period of time.
18. T

Essay Answers

1. Amortization is a procedure that evolved after the Depression to allow loans to be paid off over a period of time. During this period there is a

series of monthly payments in which a portion of each payment represents a repayment of principal as well as the interest outstanding on the loan to that point. With each payment the portion of the payment that is principal increases and the portion that is interest decreases.

2. If a borrower can take excess itemized deductions that include interest, then both income taxes and inflation lower the cost of borrowing. For example, if the taxpayer is in the 25 percent marginal tax bracket, 25 percent of the cost of borrowing is recouped in tax savings by taking an interest deduction against adjusted gross income. Additionally, inflation lowers the cost of borrowing by allowing the taxpayer to pay back money in dollars that have less purchasing power than those originally borrowed and utilized.
3. Guidelines that might be used with regard to borrowing are as follows:
 1. It is generally better to use loans to buy assets than to fund expenses.
 2. Do not let your entire indebtedness exceed your net worth.
 3. No more than 20 percent of disposable income should be used to repay debts.
 4. Debts should be completely resolved every three years so that there is a period of time when you are completely out of debt.

TRANSPARENCY MASTERS

1. Checkbook ledger (blank form from text Figure 11-2)
2. Bank statement (blank form from text Figure 11-3)
3. Statement reconciliation (blank form from text Figure 11-4)

All of these forms are also reproduced in the *Study Guide*.

12 · Borrowing: Consumer Credit

After studying this chapter, the students should be able to:

OBJECTIVES

- Explain how consumer credit works in general, and how open-ended credit and installment credit work in particular.
- Use consumer credit appropriately.
- Describe the various forms of credit cards and charge accounts.
- Define (and describe the use of) sales contracts, notes, credit life insurance, oppressive clauses, and finance charges.
- Determine which credit arrangement, among several options, offers the best terms, given their needs and financial circumstances.
- Explain the importance of the Fair Credit Reporting Act, the Equal Credit Opportunity Act, the Fair Credit Billing Act, and legislation related to unauthorized use of credit cards.
- Explain the financial principles of auto leasing.

Most of the financial considerations of borrowing covered in the last chapter apply equally to the use of consumer credit. The instructor may want to use some of the time devoted to consumer credit to reemphasize certain general concepts and procedures presented in Chapter 11, such as determining the cost of immediate enjoyment, determining the effective interest cost, and determining the effect of income taxes and inflation on the costs of borrowing.

SUGGESTED APPROACH

When addressing the question of charge accounts and credit cards, the instructor might ask students to contribute their personal experiences with these services.

With installment credit, the prime areas of consideration should be the importance of the effects that the various documents of the purchase agreement can have on the consumer. One good point of discussion is whether the buyer has any options in relation to oppressive clauses. Generally, when creditors develop contracts that contain these clauses, they are extremely reluctant to strike them out for the benefit of an objecting customer. In some instances, the consumer may prevail, but probably not as often as he or she might wish.

GUEST LECTURE IDEAS

This chapter is a very appropriate place to rely heavily on guest lecturers.

1. We have included in the transparency masters at the end of the book a copy of another type (besides the one shown in text Figure 12-1) of disclosure statement used in certain credit transactions. We suggest you invite an attorney or a representative from the local consumer assistance agency to discuss:
 - a. how the disclosure statement is filled out and what each clause means;
 - b. which clauses are in the creditor's or consumer's interest and which clauses are not;
 - c. what clauses might be added to strengthen or weaken the consumer's position.

We suggest you also invite a retailer who uses this type of document to discuss what business purposes (the retailer's) are served by such arrangements.

A panel discussion between the above parties might show up the areas where both consumers and creditors stand to gain or lose. For example, creditors have had to deal with bad debts from a small percentage of borrowers ever since the creation of credit arrangements, no doubt. To the extent that this cost is passed on to all consumers, it is in the self-interest of both creditors and consumers to see that bad debt losses are minimized. The question, however, is whether the various oppressive clauses that often find their way into credit arrangements provide the most even-handed method of dealing with such problems.

2. You might invite a representative from a credit counseling organization and one from a credit bureau to address your class. The former might cover the services offered to consumers who have misused credit. The latter might be asked to express opinions on the changes made by the Fair Credit Reporting Act, its effectiveness, and so on.

ADDITIONAL MATERIALS AND ACTIVITIES

If the instructor cannot include class visits by representatives of legal aid, credit counseling, credit bureaus, and local retailers/creditors, meeting with these people could be assigned as outside activities.

1. When visiting legal aid offices, it would be useful to find out what types of credit problems they deal with and to what extent these problems are caused by unfair practices on the part of the creditor as opposed to lack of money management skills on the part of the individual. This same line of investigation could be taken up with credit counselors.
2. When visiting a credit bureau, in addition to discussing the effectiveness of the Fair Credit Reporting Act, have your students find out about the services they provide local creditors and how their research process and credit rating system operate.
3. When visiting a local retailer/creditor, have your students ask what credit services are provided and what costs are incurred to offer these services. Have them elicit the person's thoughts on whether extending credit increases the store's sales and profits or simply prevents losing sales to competitors who do offer credit.

4. Visit a major local lender. Ask him or her how complying with the Equal Credit Opportunity Act and the Fair Credit Billing Act has changed the organization's lending procedures. Ask this individual to discuss the pros and cons of this legislation.

ANSWERS TO CHAPTER QUESTIONS

1. The six oppressive clauses that may be found are balloon clause, add-on clause, acceleration clause, confession of judgment, wage assignment, and repossession.
2. Any four of the following would be correct: interest, bookkeeping cost, allowance for bad debts, credit investigation costs, and credit life and disability insurance premiums.
3. Credit life and/or disability insurance is a potential area of abuse because creditors make a commission from insurance companies based on the value of the premiums for credit insurance they sell to their customers. This motivates the creditor to sell the insurance with the highest premiums.
4. Bank-issued credit cards generally have a wider applicability, less stringent requirements regarding credit worthiness, and no annual membership fee.
5. As a matter of convenience, provided one uses it within the limits of his or her budget categories and pays charge account and credit card bills on time to avoid paying the finance charge.
6. If the issuer has complied with all federal regulations in this matter, I am liable for the first \$50 of unauthorized use of my card only if I accepted it in the first place and then only until I notify the issuer that it has been lost or stolen. If the issuer has not complied with federal regulations, or if the use occurred after I notified the issuer of loss or theft of my card, I have no liability.
7. The credit bureau is required to disclose upon request the nature and substance of all information in my file, but they do not actually have to show me the information.
I must pay for these services if my request is not related to a rejected credit application.
According to the FTC, the maximum reasonable fee is \$25.
8. The four main areas of consideration are overturn of the holder in due course doctrine, billing errors and complaints, dates bills must be mailed, and price discounts for cash paying customers.
9. The best method from the customer's point of view is the adjusted balance method.

Student-Oriented Case Problems

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

1. There is no one answer to any of the issues raised in this case problem. However here are some guidelines for class discussion.

- It might be helpful to list the pros and cons of credit bureaus and attempt to determine whether, on balance, they are a useful or useless service.
- Review the Fair Credit Reporting Act in class to determine whether it offers any real solutions to the problems it was developed to solve. The article from *Consumer Reports* cited in the text bibliography offers some good insights into this issue.
- An appropriate question to discuss is "Do credit bureaus need to collect and report on anything other than one's debt repayment history?"

Note: Employers sometimes use credit bureaus to help screen job applicants. Should this be an acceptable use?

- One of the largest areas for inaccurate information and invasion of privacy occurs with the hearsay reports that the credit bureau obtains by sending an individual to question the credit applicant's friends, neighbors, and acquaintances about their observations and opinions concerning his interests, activities, morals, and so on. It may be useful to have the class suggest alternative methods of research and then weigh the benefits and weaknesses of their suggestions against those of hearsay reports.
2. There is a very insightful comment attributed to Frank Wright, an eminent economist at the University of Chicago: "There is no such thing as a free lunch." Translated, this means all things of value have, by definition, some cost associated with them. The key consideration, of course, is who pays this cost. Now that the holder in due course doctrine has been struck down, the consumer has some recourse where shoddy merchandise is involved and the only remaining party to the original credit transaction is the third party lender. Obviously, having lenders become responsible for resolving such situations will increase the lender's cost. This increase has been either passed on to consumers as higher borrowing rates or absorbed by the lender as reduced profits. Because this responsibility has been thrust on all lenders (within the definition of the Fair Credit Billing Act), interest rate competition among lenders subject to this act and lenders not subject to it probably will not evolve. Therefore, all lenders probably have passed most of this cost on to consumers.

Chuck and Nancy Analyzing Their Debt Structure

Chuck and Nancy would definitely want to pay off the car and furniture loans. The margin loan should be retained only as long as the Andersons feel their return on investment is exceeding its cost. The home mortgage loan is the most appropriate one of the four to keep.

One of Chuck and Nancy's best sources of funds to resolve high-interest-cost debt is the cash value in their life insurance policy. As a result of reading Chapter 9, Chuck and Nancy realized that their policy's cash value of \$4,800 was growing at an effective rate of only 2.5 to 3 percent a year. Therefore, it seemed wise to use the funds tied up in cash-value insurance to pay off the installment loans that were costing them between 12 and 15 percent a year.

Objective Questions

SAMPLE TEST QUESTIONS

Circle the letter of the correct answer to each question.

1. Which of the following is a characteristic of convenient open-ended credit?
 - a. Limited generally to higher priced items
 - b. Requires a down payment
 - c. Involves a written purchase agreement
 - d. Used for many types of purchases
 - e. (None of the above)
2. Which of the following offer credit counseling services?
 - a. Credit bureaus
 - b. Credit unions
 - c. Family service agencies
 - d. (All of the above)
3. Which of the following legislative programs is designed to protect the individual in matters of consumer credit?
 - a. Truth in lending
 - b. Fair Credit Billing Act
 - c. Equal Credit Opportunity Act
 - d. (All of the above)
4. Consumer credit may be considered a form of borrowing.

True False
5. A guardian's guarantee is required of all minors applying for consumer credit.

True False
6. Consumer credit is distinguished by the fact that disreputable practices have never been allowed to exist in this area.

True False
7. Which of the following characteristics about yourself will a creditor be interested in when you apply for credit?
 - a. Employment background
 - b. Willingness to pay
 - c. Ability to pay
 - d. (All of the above)
8. Which of the following is an extra cost to you when you buy consumer durables with installment credit rather than with cash?
 - a. Finance charges
 - b. Lost interest on savings
 - c. Sales taxes
 - d. (Both "a" and "b")
 - e. (Both "a" and "c")

9. Which of the following can you use to reduce the drain on your income due to the use of consumer credit?
- a. Pay your bills within 30 days of the billing date.
 - b. Shop around for lower interest rates.
 - c. Take the shortest payback term you can on installment credit.
 - d. Avoid using installment credit altogether and save cash for the purchase instead.
 - e. (All of the above)

Essay Questions

1. Explain how an auto leasing arrangement works.
2. Explain the difference between open-ended credit and installment credit.
3. What was the Equal Credit Opportunity Act intended to accomplish?

Objective Answers

ANSWERS TO SAMPLE TEST QUESTIONS

1. d Convenient open-ended credit is most frequently used for general merchandise purchases.
2. d
3. d
4. T
5. F This is at the discretion of the individual creditor.
6. F It was because of this that truth in lending came about.
7. d Most creditors will want this information and probably more.
8. d If you purchase an item with installment credit, you not only have the additional cost of the finance charges; you also lose the chance to earn interest on a savings account while you accumulate funds with which to make a cash purchase.
9. e All of the choices will reduce the potential dollar drain on your income due to the use of credit. Choices "a" and "d" alone will totally eliminate all expenses due to the use of consumer credit.

Essay Answers

1. A lease is merely an alternative form of financing. The leasing organization loans you the money via a lease to gain the use of a car. The value of the car is established at the beginning of the lease period, and its residual value at the end of the lease period, generally three to four years hence, is estimated. Lease payments are figured by the lessor on the difference between the initial value and the residual value plus whatever costs the lessor incurs in extending this financing to you. When this aggregate amount is divided by the number of months, the individual lease payment is determined. At the end of the lease period the car is turned in. If its trade-in value is more than the estimated residual value, the difference is refunded to the lessee. If the opposite is true, then the lessee must pay the difference between the trade-in value and the residual value.
2. Open-ended credit is a technical term used to describe the use of credit cards and charge accounts. Installment credit involves periodic payments, usually monthly, to either a retailer or a creditor to pay off whatever amounts were borrowed by the consumer to make certain purchases. In most cases, installment credit has an interest charge for the use of the money. Where open-ended credit is paid off within 30 to 60 days of its use, generally there is no interest charge.
3. The purpose of the Equal Opportunity Credit Act, passed in 1975, was to see that women were extended the same opportunities to utilize credit as had previously been extended to men. Therefore, it forbade a creditor to discriminate against a credit applicant on the basis of the person's sex or marital status.

Federal Truth in Lending Disclosure Statement (suggested for use in a guest lecture by an attorney or a representative from a consumer assistance agency)

TRANSPARENCY MASTER

13 · Automobiles and Major Appliances

OBJECTIVES After studying this chapter, the students should be able to:

- Understand the needs and emotions behind the desire for long-lived consumer durables.
- Select the product that best meets one's articulated needs.
- Shop for and negotiate the purchase of an automobile or other major appliance.
- Obtain the full useful life of the product purchased.

**SUGGESTED
APPROACH**

The content of this chapter is based largely on common sense and experience. Unfortunately, many of us are far too compulsive to patiently apply our common sense wisdom, and most of us have little buying experience when we are young. As a result, many lessons are learned by making mistakes.

Thus, we believe a useful approach would be to pool the accumulated wisdom and experience of the people in the classroom so that they may benefit from each other. Start with yourself, and introduce the class session with some ideas and experiences of your own.

- How do you decide what kind of car to buy?
- How do you shop for that car?
- What negotiating experiences have you had?

Perhaps note some good ideas on the board under each category. Then have the class participate in adding their own items to the lists. If the lists seem worthwhile, have them duplicated as a class handout.

One cautionary note: All too often, in the intellectual atmosphere of the classroom we assume that consumers should and can behave rationally. Emotional needs are often put down as being immature. Nothing could be farther from the truth. We all have emotional needs in everything from relationships, to cars, to the food we eat, to the stationery we purchase. Instead of ignoring personal emotional needs, we believe the instructor should teach the students to recognize their existence, but ask them to evaluate the financial consequences of making purchases to meet those needs. Maybe the needs are valid, but a student might prefer to spend the money on one or more other budget categories. You can't change people's emotional needs without great difficulty and much time, but you can help them to recognize those needs and learn to sort out the costs and benefits of their influence on the buying decision.

A few years ago, Barbara decided to buy the then popular new car, the AMC Hornet Sportabout Wagon. She found out the dealer's cost from her teacher's association buying service and went to the nearest dealer, who had serviced her old car satisfactorily.

SAMPLE CASE

After selecting the options, color, and so on that she wanted, she offered the salesman \$3,500 on the \$4,000 sticker price of the car she wanted to order, telling him that that was the top price she would pay or she would order the car through her buying service (a \$100 lower price but the participating dealer was 12 miles farther away). The salesman was taken aback, because he had been selling all Sportabouts for full sticker price because the manufacturer could barely keep up with demand. The dealer himself was completely out of stock.

He countered by saying that he wasn't even sure he could get the car in less than six weeks or that the owner of the dealership would want to bother at such a low price. Barbara replied, "Do you want the sale or not?"

The salesman went off to confer with the owner (supposedly) and returned saying that he was surprised at getting for Barbara the first Sportabout discount that month, \$50 off down to \$3,950. Barbara stood her ground. (Her husband, who was also along, was beginning to feel uncomfortable.) After several more "trips to the owner" and some sweaty confrontations, Barbara obtained a price of \$3,550, signed the deal, and put down a deposit.

Four weeks later, the car was delivered and Barbara went to pick it up, with a check to pay for the balance of the price. After inspecting the car and reviewing the invoice details, she found everything in order except that the car had arrived with the large 6-cylinder engine instead of the standard-sized one, and the dealer had added the extra \$60 for this option to the price.

Barbara said, "That's my car, but they put the wrong engine in it." The salesman at first claimed that was how she'd ordered it, but Barbara produced her copy of the purchase order. On the dealer's factory order, the figures had been transferred in error by the salesman or the office staff. Then the salesman said that if she didn't like it, she could order another, but it might take six to eight weeks now because of all the back orders. The salesman wouldn't mind selling her car off the floor because then he could get full sticker price.

Barbara said, "No you don't. That's my car, and I'm getting it for the \$3,550 as agreed. I'll accept the larger engine, even though I'll get poorer gas mileage. But I won't pay extra for your goof." Another series of sweaty negotiations ensued, but Barbara would not leave the office until she got her car, for \$3,550. The salesman then took her to meet the owner himself, who finally gave in when he saw she wouldn't budge.

If the instructor has a class that is unusually difficult to motivate, it might be worth spending a little extra time on the subject of buying a car, something most students can relate to. Some suggestions:

ADDITIONAL TOPICS FOR DISCUSSION

1. Get a list of available options for a popular selling car. Have the class separate them into categories of physical and emotional needs, such as safety, convenience, comfort, ego. Show the students the price of each option.

2. Give some illustrations of automobile depreciation by calculating the new price (at, say, \$500 over dealer cost), using the sources listed in the text, of several used cars advertised in your local newspaper. Calculate the annual depreciation implied by the price difference between new and used cars.

GUEST LECTURE IDEAS

1. See whether a fellow professor who teaches a course on consumer buying (perhaps you do) would present a lecture on how advertising and peer group ideas influence buying patterns. If there is time in your course plan, this could be an interesting adjunct to the material presented briefly in Chapter 1.
2. The local utility energy company might have a representative who could speak briefly on how to buy and operate appliances for greatest energy cost efficiency, and bring some pamphlets to distribute to the class as well.

ADDITIONAL MATERIALS AND ACTIVITIES

1. Have the students select the car they might want to buy, and list the reasons why they are making that choice. Then have them look up and calculate the dealer's cost for the basic car plus the options they wish to buy. If possible, also have them determine the dealer's trade-in (blue book) value of their existing car (if they don't have one, assign them one) or at least look up the asking retail price of that car on the used car market in the classified ads. What is the likely net cost of such a car switch? Have them show their calculations.
2. Assign a different model and brand of a major appliance to each small group of students and have them visit a reasonable number of local retailers of that product. List the current prices asked by each dealer, indicate those that are advertised as "sales," and also indicate the type of repair service offered by the dealer. Publish as a class handout as a basis for class discussion.

ANSWERS TO CHAPTER QUESTIONS

1. In planning your budget, you can determine the total annual cost of various alternatives if you know your approximate annual mileage. Also, by knowing the variable costs, you can determine:
 - a. the cost of various alternatives and distances in commuting;
 - b. the relative cost of taking a trip by car versus other modes of transportation

Fixed costs have no bearing on any of these decisions except the initial purchase decision.

2. No. Most appliances last longer than two years. Even during the warranty period, who wants the nuisance of repair visits resulting from the purchase of a less reliable make of appliance?
3. When selling it yourself, you can obtain most of the current retail value (with some work), while on a trade-in you must accept wholesale value to allow the dealer some profit margin for the effort in resale.

4. One, know the dealer's cost for the car and options, the wholesale cost of your car, the dealer's markup, and the competitive situation. You can't negotiate if you don't do your homework and learn the facts; the salesperson can bamboozle you with misleading facts otherwise. Two, be prepared to leave if you don't get what you believe is a fair deal.
5. First try to resolve it with the dealer. If that doesn't work, ask the dealer to arrange a meeting with the factory representative. Finally, you may have to write the company's public relations office or contact your nearest AUTOCAP office.
6. First give the firm who did the repairs a chance to solve the problem. If necessary, see the owner or manager. If all else fails, file a report with the Better Business Bureau.
7. One, follow the owner's manual instructions. Two, look for the simple remedy yourself.
8. No. The evaluation factors on which they base their ratings may not be as important to you as some other factors. Use these only as additional sources of information. Make your own final evaluation and decision.
9. From Table 13-3, design features are generally most important. There is less difference in the other three factors among competing brands.
10. Do some comparison shopping; try to negotiate a better price elsewhere by telling the salesperson of the competitor's sale. Other considerations would be convenience and reliability of the repair service offered by the dealer.

- a. $\$12,000 \times 45\% = \$5,400$ estimated 1985 resale value
- b. $\$6,600 \text{ depreciation cost} \div 72,000 \text{ miles} = 9.2¢/\text{mile}$
- c. $\$5,400 \times 1.30 = \$7,020$ (The 55% depreciation forecast was based on actual history, which included the effect of the actual inflation rate. A 30% higher inflation rate should, all other supply/demand factors remaining equal, result in a 30 percent higher resale value than projected using historic trends.)

Note also that much of the ballyhoo about some foreign cars holding their resale value better than domestic autos (some even appreciating) has probably been the result of relatively faster price increases for the new foreign cars due to the declining value of the dollar in international trade. This trend could reverse if the dollar strengthens instead of weakens.

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEM

SAMPLE TEST QUESTIONS **Objective Questions**

Circle the letter of the correct answer to each question.

1. The cost of owning a freezer is
 - a. the price you can negotiate with the dealer
 - b. the purchase cost plus energy and repair costs
 - c. the purchase cost plus operating costs plus lost interest
 - d. depreciation plus operating costs
 - e. the purchase cost, plus operating costs, plus the lost interest on your money, less the food purchasing savings
2. Which of the following is NOT a factor in evaluating your need for a particular type of consumer durable?
 - a. Initial purchase cost
 - b. Your emotional needs
 - c. Estimated operating costs
 - d. The month of the year
 - e. Review of alternative ways to fill that need
3. Which month is usually the most difficult in which to find or negotiate low prices for major appliances?
 - a. January
 - b. November
 - c. October
 - d. April
 - e. May
4. Which of the following is largely a fixed cost in owning an automobile?
 - a. Depreciation
 - b. Gas and oil
 - c. Repairs
 - d. Traffic tickets
 - e. Tires
5. Which of the following is the cheapest way for Sharon to travel to and from the family reunion (where she will not need her car) 1,000 miles away?
 - a. By plane—\$165 round-trip plus \$18 total in limousine fares to and from both airports
 - b. By bus—\$95 round-trip plus \$20 a day for restaurant meals on the two-day trip
 - c. By her car—6¢ per mile for gas and oil, maintenance and tires, plus meals and \$20 motel fee each way
 - d. Cab fare at 60¢ per mile
6. What is the first action one should take after having an unsatisfactory appliance repair job done?
 - a. File a complaint with the Better Business Bureau.
 - b. Contact the manufacturer.
 - c. Contact the manufacturer's representative in your area.
 - d. Try to resolve the problem with the firm that did the repair work.
 - e. Contact the consumer problem reporter at the local TV or radio station.

7. You should always try to negotiate a better price for automobiles as well as major appliances.

True False

8. What should one do after an auto dealer refuses to do some warranty work to your satisfaction, and you believe he is being unfair?
- a. Ask the dealer to make an appointment for you to see the manufacturer's representative.
 - b. Contact the manufacturer's public relations or complaint department.
 - c. Contact an AUTOCAP office.
 - d. File a suit in small claims court.
 - e. Refuse to patronize the dealer and take the work elsewhere.
 - f. Burn the car with news reporters present.
9. Depreciation is a function only of the age of a car; the amount of mileage driven is not a factor.

True False

10. Which of the following increases the cost of owning an automobile?
- a. Living closer to work
 - b. Buying a foreign car
 - c. Having two or more accidents and/or moving traffic violations in a 12-month period
 - d. Living in a small town instead of a major metropolitan area
 - e. Buying a two-year old used car instead of a new car

Essay Questions

1. Lee is trying to decide between a mo-ped and an economy car for his sole mode of personally owned transportation. Describe briefly two advantages and three major disadvantages to a mo-ped.
2. What are two reasons for refusing an appliance service contract offered by a dealer at an attractive rate for the first two years?
3. What purposes might an appliance dealer's "sale" banners and offer of six-month interest-free financing have in common?
4. Why should you not ignore your emotional needs when buying a car? Why should you carefully evaluate them instead of blindly yielding to them?
5. In today's high energy cost environment, why shouldn't energy use be an overriding factor in deciding among different models of some appliances?
6. Anne plans to buy a \$9,000 car and resell it in five years for about \$4,000. If she drives 10,000 miles a year, what would be her depreciation cost per mile over the five-year period? What would be the variable depreciation cost of driving an extra 100 miles one year?
7. Why would a group of three or more persons be likely to find an automobile the least expensive form of transportation for commuting or other trips involving no more than a day's drive?

**ANSWERS TO
SAMPLE TEST
QUESTIONS**

Objective Answers

1. e The other answers are an incomplete enumeration.
2. d The month of the year may affect the price and therefore affect the timing of the purchase but should not affect the evaluation of your need for a long-lived appliance. (Hot summer weather can be emotionally trying, but rationally should not affect your decision to buy an air conditioner.)
3. b The Christmas season is getting under way.
4. a The others vary with the amount of driving.
5. b At a cost of \$175. "a" would cost \$183, "c" would cost \$240 ($6¢ \text{ per mile} \times 2000 \text{ miles} = \$120 + \$40 \text{ motel and } \$80 \text{ meals}$), and "d" is a ridiculous \$1,200.
6. d Dealers usually want to have satisfied customers and a good reputation, so will do their best.
7. T What have you got to lose?
8. a This is the logical next step. Take one or more of the others if "a" fails.
9. F Excessive mileage, usually over 15,000 miles a year, reduces the resale value of a car.
10. c The rest of the choices are either ambiguous or tend to reduce the cost.

Essay Answers

1. *Advantages:* lower price (meaning less depreciation, and so on) and lower operating cost (fuel economy, and so on).
Disadvantages: less flexibility and utility (in regard to distance, load capacity, speed), less comfort (seating, weather, and so on), and less safety.
2. One, sales costs (and possible extra profit margins) of the service contract probably will result in a higher cost than the expected average repair costs. Two, the charges will almost certainly go up in the renewal periods as the appliance gets older and therefore is likely to need more frequent repair.
3. The common purposes might be either to generate high sales volume or to hide generally high prices.
4. If you don't consider all aspects of the decision, including emotional factors, you might soon be unhappy with your purchase. However, giving in to all of them might cost you money you would rather spend somewhere else in your budget.
5. Other factors, such as design features or purchase price, could be significantly more important. Also, in some kinds of appliances, there is very little, if any, difference in energy usage.

6. $\$5,000 \div 50,000$ miles equals 10¢ per mile. An extra 100 miles would cost her practically nothing in depreciation, unless she winds up putting excessive mileage on the car (generally defined as being in excess of 15,000 miles per year).
7. There is little additional cost for the additional people except for meals and a little more gas, while other transportation methods involve the cost of two additional fares.

14 • Housing

OBJECTIVES After studying this chapter, the students should be able to:

- Compare the advantages and disadvantages of renting with those of buying, particularly in regard to costs.
- Describe the factors involved in determining one's housing needs and one's price range.
- Explain the legal considerations involved in renting, with particular emphasis on tenant-landlord relations.
- Describe the most effective way to go about purchasing a home, including arranging for financing.
- Describe many of the considerations in building a home.
- Describe what must be taken into consideration when selling a house.
- Explain the advantages and disadvantages of owning a mobile home, cooperative apartment, or condominium rather than a house.
- Outline the major considerations when buying a vacation home.

**SUGGESTED
APPROACH**

Most of the topics covered in this chapter are straightforward and students rarely have trouble with them. There are two areas, however, that generally cause confusion: (1) comparing the costs of renting and buying and (2) recognizing the effect of inflation on home costs.

It is very difficult to compare the costs of renting to those of buying because rental units and units available for purchase often have different characteristics. If you can explain in class how the costs of property taxes, maintenance, obsolescence, mortgage payments, return on investment, management, vacancy allowance, and selling costs affect the homeowner, the landlord, and the renter, your discussion plus the treatment of the subject in the text should enable your students to understand what costs are involved in owning a home and how they compare to the costs covered by a rent payment. We have found the following explanations of these costs to be helpful to our students.

- *Property taxes.* Homeowners pay property taxes directly to the government. Landlords set their rents at a level that allows them to pay property taxes out of rent revenues. Renters, therefore, pay their landlord's property tax on that portion of the property that they are renting. In addition, landlords and the homeowners are allowed to deduct the amount of their property taxes as excess itemized deductions. Renters cannot.

- *Maintenance.* Homeowners pay for their own maintenance. Landlords set their rents at a level that allows them to pay for maintenance out of their rent revenues. Therefore, tenants in effect pay their own maintenance costs as a part of each rent payment. In addition, maintenance costs for renters tend to be slightly higher than for homeowners because tenants often seem not to take as good care of their homes as homeowners do.
- *Obsolescence.* This is an indirect cost that affects every property owner. It is caused by deterioration of the quality, and therefore the value, of a building due to advancing age. (For example, the quality of much of the wiring, plumbing, and construction of a unit will deteriorate over time.) Landlords pass on some of the cost of obsolescence to renters and in addition are allowed to take depreciation as an income tax deduction to offset the effect of this loss in value. Homeowners are not allowed to deduct for depreciation. Therefore, the cost of obsolescence is greater for homeowners than for renters.
- *Mortgage payment.* Homeowners pay their own mortgage payments. Landlords set their rents at a level that allows them to make their payments out of their rent revenues. As a part of the rent payment, the tenant in effect pays a portion of the landlord's mortgage payment.
- *Return on investment.* Both homeowners and landlords can profit from their investment. The homeowners' only profit opportunity comes upon resale of their home. Landlords can profit not only from rent payments but also from resale of the property. Through rent payments, the tenant provides the landlord with a profit.
- *Management.* Landlords must either compensate themselves for the time they spend managing their rental units or for the cost of having someone else do it. This cost is reflected in the tenant's rent level. Homeowners have no such cost.
- *Vacancy allowance.* Rental units are seldom 100 percent occupied. At a minimum there will be some vacancy factor due to tenant turnover, and this factor can be increased when the supply of units on the rental market exceeds the demand. Within the competitive constraints of the rental market, landlords set their rent levels high enough to cover small levels of vacancy, usually 5 percent. Therefore, each renter in a building pays a portion of the landlord's vacancy allowance. Homeowners have no such cost.
- *Selling costs.* Whenever a home or rental unit is sold, selling expenses are incurred for commissions, advertising, and the like. These can amount to as much as 7 percent of the selling price. This cost is not reflected in tenant rents. It is covered out of resale proceeds by both the landlord and the homeowner. The sooner resale occurs after purchase, the larger the costs as an annual average. This last expense, because it affects the homeowner, not the renter, and can be large in amount (as opposed to the differences between the other costs), generally makes renting a unit more economical than owning the same unit during the first one to three years. As time passes, the annual average of

the costs of owning diminishes and the costs unique to renting (i.e., vacancy allowance and management) tip the scales in favor of the homeowner. One consideration that can accelerate this process is rapidly rising home values. When a home rises in value, the profit to the homeowner may outweigh the costs of a quick resale. This profit would not be available to the renter.

The effect of inflation on home values is often difficult for students to get straight. Many people believe that one of the greatest economic merits of home ownership is that the home more or less naturally increases in value. This certainly can be true, but some clarifications are needed. An increase in value can occur for two reasons. If the demand for homes exceeds the supply, the price of homes is driven up. This is especially true of land since it is in fixed supply. Therefore, much of the increase in the value of a home is due to the increasing value of the land on which the structure stands, not of the structure itself. The second reason for which homes tend to increase in value would be that, as construction costs increase, replacement costs rise and so the value of already built structures rises accordingly.

ADDITIONAL TOPICS FOR DISCUSSION

1. We have included in the transparency masters at the end of this book an example of a document that home buyers are often confronted with during the close of escrow. Pertinent aspects of this document have been labeled with letters in Figure 14-A. An explanation of these considerations follows. (A similar document with certain alterations is used for seller's instructions.)
 - A. The balance due at the close of escrow (the same amount as shown in line 303)
 - B. The deposit or earnest money (the same amount as shown in line 201)
 - C. The mortgage (the same amount as shown in line 202)
 - D. The contract sales price (the same amount as shown in line 101)
 - E. The buyers
 - F. The mortgage lender
 - G. The date ownership transfer is recorded (often the date escrow is closed)
 - H. Debits add up to the total cost of the home purchase.
 - I. Credits are the cash and loan proceeds the buyer has put up to cover the total cost of purchase (therefore, the sum of debits and credits columns must be equal).
 - J. The total settlement charges (lines 704-1305 as appropriate and summed in line 1400 on the second page of the instructions)
 - K. Certain home owning costs, such as property taxes, that the seller has prepaid for a period greater than his term of ownership
 - L. A second deed of trust, if utilized, would be entered here.
 - M. The opposite of the items under "K"—that is, amounts owed by the seller during his term of ownership
 - N. Normally paid by seller, so no entry is made here
 - O. These items, all or in part, are required by the lender.

BORROWER'S/BUYER'S INSTRUCTIONS

TRANSAMERICA TITLE INSURANCE COMPANY

Date _____

Escrow Number _____

Enclosed herewith are:

CHECK in the amount of \$ A. CASH in the amount of \$ B. PROMISSORY NOTE and DEED OF TRUST C.

(Documents and terms thereof have been examined and approved by Borrower/Buyer)

You are hereby authorized to deliver and/or record all of said documents and disburse said funds, together with the proceeds of any deed of trust mentioned below, on account of the purchase price for the real property described in your above numbered escrow and on account of the other costs, fees and adjustments in that connection, when you can issue your ☐ Standard Coverage form Title Insurance Policy in the amount of \$ D., insuring title as vested in the name of: E.

☐ Standard ☐ ALTA policy of title insurance for not less than the amount of the enclosed Deed of Trust, with _____ indorsement form No. _____ attached, insuring said Deed of Trust to be a lien or charge upon the real property described therein.

SUBJECT TO: COUNTY and/or CITY TAXES not delinquent; BONDS and/or SPECIAL ASSESSMENTS not delinquent; and COVENANTS, CONDITIONS, RESTRICTIONS, RIGHTS of WAY, EASEMENTS and RESERVATIONS now of record.

DEED OF TRUST in favor of F.

DEED of TRUST in favor of _____

Pro-rate as of G. (based on a 30-day month); ☐ Real Property Taxes (based on the latest available tax bills);

☐ Fire Insurance Premiums; ☐ Interest on Existing Loan; ☐ Rents (based on statements provided by Seller); ☐ Upkeep Charge.

Credit to Seller ☐ Existing loan trust fund. Credit to Buyer ☐ Security deposits.

LINE	ESTIMATED STATEMENT	H. DEBITS	I. CREDITS
101.	Contract sales price		
102.	Personal property		
103.	Borrower's/Buyer's charges (Ln. 1400 - Page 2) <u>J.</u>		
104.			
105A.			
105B.			
105C.			
105D.			
105E.			
105F.			
105G.			
105H.			
	ADJUSTMENTS FOR ITEMS PAID BY SELLER IN ADVANCE <u>K.</u>		
106.	City/town taxes \$ _____ to _____		
107.	County taxes \$ _____ to _____		
108.	Assessments \$ _____ to _____		
109.			
110.			
111.			
112.			
	AMOUNTS PAID BY OR IN BEHALF OF BORROWER/BUYER		
201.	Deposit or earnest money		
202.	Prin. amt. of new loans		
203.	Existing loan(s) taken subject to		
204.	<u>L.</u>		
205.			
206.			
207.			
208.			
209.			
	ADJUSTMENTS FOR ITEMS UNPAID BY SELLER <u>M.</u>		
210.	City/town taxes \$ _____ to _____		
211.	County taxes \$ _____ to _____		
212.	Assessments \$ _____ to _____		
213.			
214.			
215.			
216.			
303.	Balance due to/from this escrow (estimated)		

L. SETTLEMENT CHARGES

LINE	AMOUNT
704	COMMISSION N.
705	
800	ITEMS PAYABLE IN CONNECTION WITH LOAN: O.
801	Loan Origination % to
802	Loan Discount % to
803	Appraisal Fee to
804	Credit Report to
805	Lender's inspection fee
806	Mortgage insurance application fee to
807	Assumption/refinancing fee
808	Tax Service to
809	
810	
811	
900	ITEMS REQUIRED BY LENDER TO BE PAID IN ADVANCE: P.
901	Interest from to @ \$ /day
902	Mortgage insurance premium for mo. to
903	Hazard insurance premium for yrs. to
904	for yrs. to
905	Reconveyance fee
1000	RESERVES DEPOSITED WITH LENDER FOR: Q.
1001	Hazard insurance mo. @ \$ /mo.
1002	Mortgage insurance mo. @ \$ /mo.
1003	City property taxes mo. @ \$ /mo.
1004	County property taxes mo. @ \$ /mo.
1005	Annual assessments mo. @ \$ /mo.
1006	mo. @ \$ /mo.
1007	mo. @ \$ /mo.
1008	mo. @ \$ /mo.
1100	TITLE CHARGES: R.
1101	Settlement or closing fee
1102	Abstract or title search
1103	Title examination
1104	Title insurance binder
1105	Document preparation
1106	Notary fees
1107	Attorney's fees
1108	Title insurance to
1111	Indorsement
1112	
1113	
1200	GOVERNMENT RECORDING AND TRANSFER CHARGES S.
1201	Recording charges Deed \$ Mortgage \$ Releases \$
1202	City county tax/stamps Deed \$ Mortgage \$
1203	State tax/stamps Deed \$ Mortgage \$
1204	
1300	ADDITIONAL SETTLEMENT CHARGES T.
1301	Survey
1302	Pest inspection
1303	
1304	
1305	
1400	TOTAL SETTLEMENT CHARGES (entered on line 103)

These instructions are effective _____ and thereafter until revoked by written demand on you by the undersigned or any one of them. I hereby agree to pay all my proper costs and fees, including any adjustments, and request you to remit balance to me at the address shown below.

If you are the prevailing party in any action or proceeding between you and some or all of the parties to this escrow, you shall be entitled to all costs, expenses, and reasonable attorney's fees expended or incurred in connection therewith. If you are required to respond to any legal summons or proceedings not involving a breach or fault upon your part, the parties to this escrow jointly and severally agree to pay all costs, expenses, and reasonable attorney's fees expended or incurred by you, and the parties hereto further agree to indemnify you against all loss and expense in the said action or proceeding.

- P. These items are often required by the lender to span the period from the time the home purchase is made to the time the mortgage loan begins its amortization (i.e., the buyer begins making payments), rarely more than 30 days.
 - Q. Amounts to be impounded in advance and often without interest to the buyer to be used in the future to pay property taxes and the like
 - R. Amounts charged by the title insurance company to the buyer during escrow
 - S. Local government charges for recording deeds, transferring title, and other transactions.
 - T. Costs of lot survey and house termite inspection.
2. In the *Study Guide* students are given a three-page lease. You might want to go over in class the elements in this blank form, highlighting the crucial clauses.

The difference between investing and speculating was demonstrated to Ray Hansen recently. The former involves committing funds to an activity because of its fundamental economic soundness. The latter involves making money from the emotional panic of others. In Ray's case, he entered the bidding process on a group of to-be-built condominiums in a project near Napili, Maui. In recent weeks, similar bidding experiences had been frantic on other projects, but successful bidders found they could resell their condominiums within days at even higher prices to others. Thus Ray entered this particular day's auction intent on buying several units, each for resale. He bid aggressively and landed five condominiums. Unfortunately, Ray discovered within the next two weeks that he had become the proverbial dancer left standing without a chair when the music stopped. As it happened, the prices paid to the developer by Ray and other purchasers that day far exceeded what the general body of condominium buyers was willing to pay for such units. Ray talked himself into paying such prices because he mistakenly assumed he would have no trouble finding others to resell to, no matter what the price. He also got carried away by the fervor of the auction.

SAMPLE CASE

One of the most fruitful uses of class time might be to expose your students to various practitioners in the housing community. Therefore, we would recommend inviting several guest lecturers as cited next to address your students.

GUEST LECTURE IDEAS

1. Ask a knowledgeable representative of your local planning commission to discuss both local zoning laws and the process by which these laws are enforced. Have him or her discuss the long-term trends he or she sees for the community.
2. Ask a prominent residential realtor to discuss both the types of rental units available and the market for homes in your community. Ask the person to describe the services he or she offers, how he or she determines both the clients' needs and what they can afford, and how he or she goes about finding living accommodations to suit a client's particular situation.

3. If there is a VA or FHA office nearby, have one of their representatives explain the housing-related services available to veterans and nonveterans. Have him or her (1) describe pending legislation, if any, that would curtail or improve these services and (2) discuss whether he or she believes an organization as large as the federal government can effectively help the average citizen with housing needs.
4. Ask an attorney who represents landlords and/or home buyers what services he or she offers. Does he or she help write the lease agreement? Is a lease always biased in the interests of the landlord? How is the tenant protected? What measures of redress are available to tenants? What things should a prospective home buyer watch out for in purchase agreements? Does he or she represent his or her clients in price negotiations? If so, does he or she feel he or she is more qualified to do this than a realtor?
5. Ask a local housing lender to address how he or she determines how much to loan people for home mortgages. Ask him or her to also discuss alternative forms of financing such as second mortgages.

ANSWERS TO CHAPTER QUESTIONS

1. Renting has unique costs to allow for management fees and vacancies and provide a return on the landlord's investment. Home ownership may incur the cost of resale of the house, an expense that does not affect the renter.
2. When the value of my home has increased at a rate greater than the rate of inflation. Also, an increased equity in my existing house may enable me to purchase another, more expensive house, particularly if my ability to afford a larger mortgage has also improved during the period of owning my current house.
3. An attorney will ensure that the legal agreements I enter into are in my best interests. He will confer with me and/or represent me in any legal negotiations. A house inspector will provide me with a report as to the structural soundness and condition of the house I propose to buy. A realtor will help me find a house that fits my needs and does not exceed my financial limitations. He or she will confer with me and/or represent me in many of the negotiations with the seller and can also help me to find home financing sources. These services should enable me to obtain good value and a correct and appropriate purchase agreement for my money.
4. I can determine whether a realtor is competent and honest by finding out whether he or she is licensed, active in the area in which I wish to buy, and has exclusive listings; whether he or she uses high pressure techniques, has obviously overpriced listings, has mostly listings offered by other brokers, or seems inexperienced; and whether his or her reputation is good with local lending sources, the Better Business Bureau, and the local board of realtors.
5. When the down payment and the first mortgage do not cover the purchase price plus closing costs.

6. The FHA offers mortgage insurance, and the VA offers loan guarantees.
7. Points are a front-end finance charge (in the form of either a loan origination fee or a rate differential) that exists to compensate mortgage lenders for the front-end costs of originating all types of mortgage loans (loan origination fee) and to compensate for revenues lost on governmentals (FHA and VA loans) when the rate allowable on such mortgages is less than that available on conventional mortgages (rate differential). One point equals 1 percent of the amount borrowed. The number of points charged in loan origination fees ranges from one to two and one-half points per loan. In the case of rate differentials, two points are generally charged for each quarter of one percentage point difference between interest rates on governmental and conventional mortgages.
8. A deposit receipt is important because it is a binding legal contract specifying the terms of the purchase as agreed to by the buyer and seller. If the buyer defaults on the contract, he forfeits his deposit money.
9. The purpose of title insurance is to compensate a buyer financially for loss due to faulty title to real property he or she has purchased.

Student-Oriented Case Problems

1. There are two financing plans to be evaluated for each housing alternative. If they decide to purchase the house, the initial expenses exclusive of down payment will be \$3,300 (\$2,500 for furnishings and \$800 for closing costs). Buying a three-bedroom, two-bath home would be foresighted if they plan to have another child in the very near future because they could count on remaining in this home for several years, thereby keeping their average annual housing costs down. The problem with this housing alternative is that both methods of financing it put a strain on their financial resources.

If \$15,000 is paid out as a down payment, the combined \$18,300 front-end costs would eliminate their mutual fund investment and reduce their emergency savings account to \$10,200. This might be acceptable if the house were a very important goal for the Carrs, provided they could easily carry the ongoing costs of the house. As it turns out, carrying costs are a problem. The combined monthly costs of mortgage payments (\$399) and other regular monthly costs (\$90) total \$489 (41 percent of the Carr's take-home pay). This is probably too large a portion of their budget to be realistically achievable.

The other financing alternative (\$5,000 second mortgage) would leave the Carrs with their savings account and \$2,900 of their mutual fund investment intact, but raise their monthly costs for the first five years to \$595, or 50 percent of their take-home pay. This would be an almost impossible financial burden.

If Terry and Andrea decide to purchase the condominium, their initial costs for furnishings will be \$2,500 and for closing the deal \$600—\$3,100 total. If they decide to put \$10,000 down, they would have to eliminate \$13,100 from their mutual fund investment and savings account. This would pose no great financial threat, unless they were trying

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

to accumulate some extra financial resources to meet the future costs of family formation. The monthly costs of \$408 represent 34 percent of the Carr's take-home pay—a tolerable financial situation, particularly if Terry expects his income to rise.

The last financing alternative represents the least reduction in the mutual fund and savings account. The monthly costs would then total \$472 or 39 percent of take-home pay for the first five years. This poses a cash problem but could be justified as a somewhat risky investment.

It is financially sound, though risky, to assume second mortgages with interest rates of 10 percent if the interest charges can be deducted (excess itemized deductions against adjusted gross income) at ordinary income tax rates and the 10 percent return on the mutual fund will be taxed at long-term capital gains rates.

Our answer to this case problem is that the condominium, with a \$10,000 down payment, is probably the best alternative for the Carrs. Other possible conclusions the students may draw, with accompanying qualifications, might be for the Carrs to:

- Continue renting if they can rent acceptable quarters for less than \$325 a month.
 - Buy the house, with \$15,000 cash down, if they can manage on a tight budget and envision the need for larger quarters in the near future, and Terry has good reason to expect his job to be secure and his income to rise significantly.
 - Buy the condominium with \$7,000 cash, assuming the \$3,000 second mortgage bearing 10 percent in the hope of making a greater after-tax profit on their investments than the after-tax cost of the second. (But they must be aware that losing money on this option is a distinct possibility.)
 - One further possibility would be to reduce the initial outlay for furnishings and appliances in order to make one of the above options more feasible. They would then have to defer such purchases until their income was high enough or they had saved enough money to pay cash, rather than using high-cost consumer credit.
2. The Dowdreys' offer was only 8 percent below the seller's offering price, a good place to start negotiations if the Dowdreys are willing to pay approximately \$62,500 for this particular home. A likely interpretation of the seller's response, countering with a mere \$250 reduction in his offering price, is that the seller has no intention of selling his home for significantly less than \$65,000. Alternatively, he may be trying to "smoke out" the Dowdreys—that is, see how willing and serious they are about negotiating a lower price.

At this juncture, the Dowdreys might try any of these approaches:

- a. Increase their offer by \$250. This would indicate to the seller that they consider his first counteroffer as insignificant and are determined to negotiate vigorously.
- b. Raise their offer to \$61,000 in an attempt to get the seller to begin countering with significant price cuts. This strategy could backfire if the seller misinterprets this action as a sign of negotiating weakness and either remains firm in his first counter of \$64,750 or comes down only another \$250.

- c. Deliver a "take it or leave it" offer of \$62,000. The reason \$62,000 is used instead of \$62,500 (the price they are willing to pay) is that "take it or leave it" offers occasionally "smoke out" the seller, but a \$500 cushion must be retained to give the seller a method of graciously reducing his asking price. For example, upon receiving this offer, the seller might come down from \$64,750 to \$63,000. The deal can easily be consummated at \$62,500 (what the Dowdreys were willing to pay all along) without loss of face to the seller. Obviously, this strategy should not be used if the Dowdreys are not willing to walk away from the deal if they do not get a satisfactory response from the seller.

The information needed about the seller is simply why is he selling his house. If he has been transferred to a job out of state and must leave shortly, then the buyer may have some leverage in the negotiations. If the seller is under no pressure to get the house sold quickly, then the Dowdreys' negotiating position is much less strong.

Chuck and Nancy Anderson Buying a New Home

1. The Andersons should make sure the new house fulfills their needs in regard to both the location of the property and the physical aspects of the building itself.
2. I would need information about how their new annual recurring housing costs would fit into their budget and what percentage those costs would be of their take-home pay.
3. Taxes and inflation would reduce the rate the Andersons must pay on their mortgage to 2.125 percent, assuming a 25 percent marginal tax rate and a 5 percent annual inflation rate.

$$\begin{aligned} 9.5\% \text{ mortgage rate} \times 25\% \text{ MTR} &= 2.375\% \text{ tax savings} \\ 9.5\% - 2.375\% - 5\% \text{ inflation} &= 2.125\% \end{aligned}$$

4. Because the new house is more expensive, property taxes are likely to be higher. If it is a larger house, gardening and utility costs are also likely to be higher. Because it is a new house, the cost of repairs is likely to be lower.

SAMPLE TEST QUESTIONS **Objective Questions**

Circle the letter of the correct answer to each question.

1. Decisions about buying a home are easy to make because only economic considerations are involved.

True False

2. Owning is more economically feasible than renting, no matter how many years you plan to occupy a house.

True False

3. Which of the following costs is NOT related to owning?

- a. Property taxes
- b. Maintenance
- c. Mortgage interest
- d. Obsolescence
- e. Management fee
- f. (None of the above)

4. Which of the following is an advantage of home ownership?

- a. Feeling of security and permanence
- b. Increased civic responsibility
- c. Pride of ownership
- d. (All of the above)

5. A home down payment sometimes poses an undue strain on one's financial resources.

True False

6. Which of the following is a cost for renters, but NOT for homeowners?

- a. Investment profit on operations
- b. Utilities
- c. Mortgage loan repayments
- d. Property taxes
- e. Maintenance
- f. (None of the above)

7. A rule of thumb often used to determine the appropriate price range in which to look for a home is three and one-half times your annual after-tax income.

True False

8. Which of the following is a characteristic of an older house?

- a. Easier to resell
- b. Usually located farther from central cities
- c. Down payments are smaller
- d. Mortgage maturity is longer
- e. More square feet for same price
- f. (None of the above)

9. A good real estate agent will NOT
- use high pressure tactics
 - have exclusive listings
 - solicit your reasons for buying
 - inform you of local conditions
 - (None of the above)
10. Which of the following are basic cost elements of buying a home?
- Down payment
 - Mortgage
 - Closing costs
 - (All of the above)
11. Which of the following is NOT a type of mortgage loan?
- FHA Title II, Sec. 203 (b)
 - VA home loan
 - Escrow earnest money
 - Conventional home loan
 - (None of the above)
12. Both the VA and the FHA make home loans.
- True False
13. The condition of the title to a piece of property can be determined by a title search.
- True False
14. Which of the following is an alternative form of home ownership?
- Condominium
 - Cooperative apartment
 - Mobile home
 - (All of the above)
15. Deciding whether or not to build your own home is an endeavor to be approached with much thought and investigation.
- True False

Essay Questions

- Explain the effect of inflation on home ownership.
- Describe several of the items that should be included in a lease agreement.
- Describe the negotiating process for buying a home.

**ANSWERS TO
SAMPLE TEST
QUESTIONS**

Objective Answers

1. F Any decisions you make about the purchase of a home will be based on many considerations in addition to economic ones.
2. F Several studies have shown that for up to three years in a home it is usually more economical to rent than to buy.
3. e A management fee is only a consideration in the computation of rent.
4. d
5. T One should always examine one's balance sheet to determine the effect of a proposed down payment.
6. a Investment profit on operations is a consideration for the owner of income-producing properties. (A homeowner may profit on resale, not on operations.)
7. F The rule of thumb is two and one-half times your annual after-tax income.
8. e The other items listed are usually characteristics of new houses.
9. a Failure to do the other options would indicate a poor real estate agent.
10. d
11. c Earnest money is a deposit you make to signify your intention to buy a home.
12. F Neither make loans as a general practice; they guarantee or insure them.
13. T
14. d
15. T

Essay Answers

1. Inflation tends to have a positive effect on the value of homes, in that real estate generally increases in value at least as fast as inflation does. One of the benefits that can occur from this is that the value of a homeowners' equity increases. Thus, a homeowner may be able to sell his or her original home and buy a more substantial one because of the increase in equity that occurred during the period that he or she held the original house. This upgrading becomes all the more possible if his or her ability to take on a larger mortgage has also increased during this period.
2. In a lease agreement the things that generally should be included are as follows: (a) the amount of the rent; (b) the amount of the deposit plus the terms on which it either will be used to cover a cleaning charge at the end of your use of the premises or will be returned to you upon the successful conclusion of the agreement; (c) the term of the agreement;

(d) whether landlord or tenant pays such items as utilities, repairs, replacements, and insurance; (e) any restrictions on the tenant's activities such as subletting the apartment; the use of musical instruments, television, or the like; the appropriateness of pets, children, overnight guests.

3. Most homes are generally bought and sold via the negotiation process. The seller initially establishes an asking price somewhat in excess of what he is ultimately willing to accept on the sale. It is then the buyer's obligation to make an initial offer between 5 and 20 percent below the asking price. After these two initial parries have been made, usually the seller gradually reduces his asking price and the buyer gradually increases his offering price until an agreed upon price is reached. In addition to the price, there is often negotiation about other terms of the purchase such as who will pay for pest control damages and who will pay for any repairs needed.

Borrower's/Buyer's Instructions (For explanation of items, see "Additional Topics for Discussion" in this chapter.)

**TRANSPARENCY
MASTER**

15 · Investment Principles

OBJECTIVES After studying this chapter, the students should be able to:

- State how they can save money to build up their investment assets.
- List their investment objectives.
- Design and explain a fundamental strategy for achieving their investment objectives, given the constraints of expected investment return, taxes, and inflation.
- Explain the nature of investment risk.
 - Define and explain the fundamental concepts of income, compound yield, liquidity, and maturity.
- Explain the effect of inflation on investment lending positions and on investment ownership positions.

SUGGESTED APPROACH The following topics are deemed to be the most useful for classroom review.

1. *Techniques for saving money.* Many people complain that they would love to be able to invest but cannot save any money. For most people, the problem is lack of self-discipline. If you discuss in class the saving techniques described at the beginning of Chapter 15 in the text and use an example of each that you feel would be meaningful to your students, you can illustrate clearly many of the methods that can be used to develop self-discipline in saving. Emphasize to your students how effective a regular savings habit can be, regardless of how small an amount they can regularly set aside. Point out to them that even by investing only \$10 a week at a 6 percent average return they can build up investment assets totaling \$28,548 in 25 years. Many people go through life looking for a get-rich-quick scheme; but in our experience a \$30,000 income family can have as large a net worth as a \$60,000 income family as long as they have good savings habits and make wise investments.

2. *Investment risk.* Be certain your students understand that an investment offering high potential return always has a high element of risk in it, no matter how certain the outcome may seem. Point out to them that whenever they are considering making an investment, they should first figure out what the potential risks of the investment are; only then can they realistically decide whether to accept those risks, do something to minimize them, or look for another investment. Give examples of the components of risk as they affect different investments.

Explain to your students that their risk tolerance level can rise as they learn more about higher risk investments. However, it is important for them to realize that investors who exceed their risk tolerance level are likely to make emotional and irrational decisions that will increase the risks attached to the particular type of investment. This is particularly true in the stock market.

3. *Investment concepts.* Depending on the ability level of your students, you may wish to review any or all of the following topics in class.

- Types of investment income
- Compound yield. If you can run through in class several examples of each of the ways to use compound interest Tables A and B, your students should be able to work with them successfully. We have found that if we don't do this, students seem to be overwhelmed by the pages full of numbers and have difficulty using them on their own.
- Inflation and its effect on lending and owning positions. Point out the long-term advantages of ownership positions.

4. *Rate of return.* To avoid confusion, point out to your students that the following terms mean roughly the same thing in common usage: rate of return, effective yield, effective rate of return, return on investment (R.O.I.), return, investment yield, yield. However, be certain they understand that in some usages, the term *effective* is used specifically to mean reinvestment of all current income in order to achieve the effective compound return. For example, a bond with an interest yield of 7 percent actually has an effective yield of 7.12 percent because of compounding of the semiannual interest payment.

5. *Establishing investment objectives.* Again, the instructor will probably have to resort to motivational lecturing to get across the value of setting realistic objectives early in life. A common example with which your students may be familiar is parents who wait until their child turns 15 or 16 before they begin to try to amass the thousands of dollars needed for higher education. If they had started 10 years earlier, they might have realized this objective without having to impose several years of some degree of financial struggle on everyone in the family.

You might also discuss the correlation of risk levels with the hierarchy of goals.

Type I	lowest risk
Type II—A	low to moderate risk
—B	high risk possible
Type III—A	low to moderate risk (depending on length of time to retirement)
—B	high risk possible
Type IV	your choice

6. *11-step procedure.* Tie the 11-step procedure in with the budget. This can be time-consuming if done rigorously, but the instructor should at least go back and relate the long-term goal category of the budget to this new procedure. In addition, the Chuck and Nancy case problem for this chapter is an effective vehicle for classroom illustration of this planning procedure.

Note: For those instructors who prefer to use the more detailed 12-step procedure for investment planning that appeared in the first and second editions of the text, we have reprinted it in an appendix to this chapter of the guide. You may reproduce it for classroom use.

SAMPLE CASES

1. One rainy winter afternoon when I was a junior in high school, Dad and I were painting the living room together while enjoying the football game on the radio. I noticed, after a while, that my dad had been very quiet, and I asked him what the matter was. He said, "You know, son, I've been thinking. It's only about a year and a half until you go away to college." "Yeah, isn't that great!" "Yes, it is," he said. "But I haven't really been planning ahead very well. I don't have much money set aside for you to go to college. I wonder how we're going to manage." Suddenly I realized what his problem was; I forget how the football game ended.

But things worked out. Dad and Mom started to save money from then on until I went to college. Mom got a job for the first time since before the children were born (and she's still working and enjoying it). I applied for and received not only a student loan, but also a college scholarship.

2. This is the story of Walt and George, brothers. They were both raising their families during the 1950s and had good blue-collar jobs. One of them looked ahead to the future and said, "You know, I can barely make ends meet now. I couldn't save much money even if I tried. So, I guess I'll just go on and live life and hope that my pension and my Social Security check take care of me when the time comes."

Walt, on the other hand, said, "I think you really ought to do what I'm doing. I'm saving \$10 a week in my credit union account." George thought that was a silly, insignificant effort at saving money. Walt said, "No I think it will work. I've already got \$280 saved up in my account." So over the years Walt developed a habit of saving a little money and somehow he always managed to make his money go just about as far as his brother, but he also was building up some net worth. Part of watching his money was being just a little more careful about how he spent it or the prices he paid for some things. Over the years he would increase his savings rate to \$20 a week and then finally \$30, \$40, and \$50 a week. Then he learned how to start investing in mutual funds, and even buying some of his own stocks and bonds. Finally, he started getting enough money together that he bought real estate syndication shares, \$3,000 worth at a time. Today, 1979, Walt not only has his home equity, which is substantial; he also has no debts and over \$200,000 investment net worth. All that started from \$10 a week.

ADDITIONAL TOPICS FOR DISCUSSION

Since most investors do their investment planning based on their own knowledge and experience, they are generally heavily influenced by their perspective of only the most recent years. They then extrapolate from them as though they were a straight line stretching into infinity. For example, "Now that inflation is 10 percent annually, today's \$100,000 home will be \$1,080,000 in 25 years!"

To give a longer historical perspective, we have reprinted in an appendix a paper on Kondratieff cycles. Originally written in 1977, it was reduced in length and published in 1979.

We believe that the planning concepts in Chapter 15 can be adequately presented only by an instructor familiar with this text.

GUEST LECTURE IDEAS

1. Have your students compute accurate regular investment compound interest tables. This will help the class understand their construction. For example, for \$1 invested each month for one year in a 5 percent savings account giving daily interest, factors for the first three months' investment would be derived as follows:

$$\$1 + (\$1 \times 0.05 \times 12/12) = 1.050 \text{ factor for the first month}$$

$$\$1 + (\$1 \times 0.05 \times 11/12) = 1.046 \text{ factor for the second month}$$

$$\$1 + (\$1 \times 0.05 \times 10/12) = 1.042 \text{ factor for the third month}$$

This procedure will allow you to construct monthly compound interest tables. If you want to get the factor for the whole year, carry out these computations for the other nine months and then total the factors for the 12 months. The total will be the factor for one year for \$1 invested each month in a 5 percent savings account giving daily interest. If the above example were carried out for the rest of the year, the factor for year one in the table would be 12.324. Thus your monthly investment of \$1 at 5 percent giving daily interest would amount to \$12.32 at the end of 12 months.

2. Have your students apply the 11-step procedure for planning investments and achieving goals (pp. 361-65 in the text) to their own or their parents' objectives and financial resources. This would be a particularly useful exercise once students have completed Unit IV and have a better understanding of how and when different investment alternatives are best utilized. A copy of the worksheet that we recommend using when following this procedure has been included in the *Study Guide* and at the end of this guide.

ADDITIONAL MATERIALS AND ACTIVITIES

1. $\$3,000 \times 1.8 = \$5,400$
 $\$3,000 \times 3.9 = \$11,700$
2. I would have \$7,920 ($\$600 \times 13.2$).
3. Investment risk is the chance of future loss on an investment; it is also the chance of not making what you expect on an investment. The components of investment risk are inflation risk, deflation risk, business risk, interest rate risk, market volatility risk, and liquidity risk. Psychological risk is another factor that can further affect the intrinsic investment risks. To reduce risk, investors should gain knowledge and expertise and diversify their portfolios, both among investment media and within each media group.

ANSWERS TO CHAPTER QUESTIONS

4. A \$7,000 automobile will cost \$18,200 ($\$7,000 \times 2.6$) 20 years from now.
5. I would have to invest \$1,785 ($\$10,000 \div 5.6$) at the end of each year.
Your students could also compute this on an after-tax basis. Using a 33 percent tax bracket for a net 4 percent return, the answer would be that \$1,852 ($\$10,000 \div 5.4$) would have to be invested at the end of each year.
6. Lenders have a return only of their dollars, not of purchasing power (or value of their dollars). Ownership investments have an intrinsic value that would rise in terms of dollars in relation to the reduction in purchasing power of the dollar.
7. The four strategies are:
 - Increase your initial investment to \$2,461 ($\$3,200 \div 1.3$) and invest in a 6 percent savings account.
 - Invest \$107 each year in addition to the \$2,000 lump sum ($\$2,000 \times 1.3 = \$2,600$ and $\$107 \times 5.6 = \$600$).
 - Wait until year eight to achieve the goal ($\$2,000 \times 1.6 = \$3,200$).
 - Reduce your goal level to \$2,600 ($\$2,000 \times 1.3$).

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

Student-Oriented Case Problem

The Todds are newly married young people with a problem typical of students: their aspirations exceed their immediately foreseeable resources. Figure 15-A illustrates one of many possible solutions to this problem, depending on what inflation rates and investment returns are chosen and what the \$3,800 lump sum is applied toward.

1. The camper is inflated at the 5 percent rate typical of manufactured goods. The others (real estate and services) are inflated at 6 percent, with medical services being one of the fastest rising costs. In view of the past five years' experience, these inflation rates could be set at 6 to 8 percent to be safer. It would also be correct if your students separated the second goal into two categories, and showed \$10,000 for home with inflation at 6 percent or more and \$3,000 for furnishings with inflation at 5 percent.
2. See Figure 15-A for the adjusted amount needed for each goal.
3. See Figure 15-A for the amounts to be invested for each goal. We have used the 6 percent return for a liquid investment portfolio (savings plus stocks, bonds, and mutual funds) because of the generally short-term nature of the goals.
4. The Todds find themselves \$15 short of achieving even their third goal of the baby. However, they may be able to achieve all their goals since, after year four, they will not have to continue saving for the house and will thus free up significant annual savings (depending on the after-tax cost of carrying the home.) In any case, they will probably have to defer the acquisition of their camper.
5. If one parent stops working in five years, they should be certain they can support their lifestyle, including home and baby, on the other parent's income alone. If not, they should reevaluate their goals.

NAME(S): <u>Mike and Mary Todd</u>								
DATE: <u>Using a 6 percent after-tax investment return</u>								
WORKSHEET FOR PLANNING INVESTMENTS AND ACHIEVING GOALS								
A	B	C	D	E	F1	F2	G	H
Goal	Amount Needed	Years	Inflation Factor ^a	Adjusted Amount Needed (B X D)	Return Factor from Table		Lump-Sum Investment ^d (E ÷ F1)	Annual Investment ^b (E ÷ F2)
					A ^a	B ^b	<u>\$3,800</u>	<u>\$3,600</u>
<u>Caribbean trip</u>	<u>\$1,500</u>	<u>2</u>	<u>6% (1.1)</u>	<u>\$1,650</u>	<u>1.1</u>		<u>\$1,500</u>	
Amount remaining							<u>2,300</u>	
<u>Home & furniture</u>	<u>\$3,000</u>	<u>4</u>	<u>6% (1.3)</u>	<u>\$16,900</u>	<u>1.3</u>	<u>4.4</u>	<u>\$815^c</u>	<u>\$3,600^a</u>
Amount remaining							<u>1,485</u>	<u>0</u>
<u>Child</u>	<u>\$1,500</u>	<u>5</u>	<u>6% (1.3)</u>	<u>\$1,950</u>	<u>1.3</u>		<u>1,500</u>	
Amount remaining								
<u>Camper</u>	<u>\$1,800</u>	<u>7</u>	<u>5% (1.4)</u>	<u>2,520</u>				
Amount remaining								
Amount remaining								
	(To be computed in Chapter 21)			(To be computed in Chapter 21)				
Amount remaining								

^aRefer to compound interest Table A.

^bRefer to compound interest Table B.

^cThe \$3,600 annual savings yields \$15,840 over four years, so there is \$1,060 remaining to be satisfied by the lump sum investment of \$815.

Fig. 15-A. A possible solution for Todd case problem.

Chuck and Nancy Anderson Planning Investments and Achieving Goals

As shown in Figure 15-B, the Andersons were able to achieve most of their priority goals with their existing financial resources. For their retirement goal, the projected value of \$3,100 invested at 7 percent for 30 years is \$24,500.

Although the Andersons do not have the cash today to set aside for their boat, they should have an additional \$1,500 annually to save toward retirement, a boat, or other goals once the furniture is bought in three years. For this reason, one ought to calculate a new 11-step procedure annually, or at least each time a major goal is achieved, so that new value decisions and allocation decisions can be made.

A	B	C	D	E	F1	F2	G	H
Goal	Amount Needed	Years	Inflation Factor ^a	Adjusted Amount Needed (B X D)	Return Factor from Table		Lump-Sum Investment ^b (E ÷ F1)	Annual Investment ^b (E ÷ F2)
					A ^a	B ^b	\$17,300	\$2,400
<i>Jim's college</i>	<i>\$8,000^c</i>	<i>10</i>	<i>(6%)1.8</i>	<i>\$14,400</i>	<i>2.0</i>		<i>\$7,200</i>	
Amount remaining							<i>10,100</i>	
<i>Melissa's college</i>	<i>8,000^c</i>	<i>13</i>	<i>(6%)2.1</i>	<i>16,800</i>	<i>2.4</i>		<i>7,000</i>	
Amount remaining							<i>3,100</i>	
<i>Furniture and carpets</i>	<i>4,000</i>	<i>3</i>	<i>(5%)1.2</i>	<i>4,800</i>		<i>3.2</i>		<i>1,500</i>
Amount remaining								<i>900</i>
<i>Replace car</i>	<i>3,000</i>	<i>4</i>	<i>(5%)1.2</i>	<i>3,600</i>		<i>4.4</i>		<i>818</i>
Amount remaining								<i>72</i>
<i>Motorboat</i>	<i>6,000</i>	<i>15</i>	<i>(5%)2.1</i>	<i>12,600</i>		<i>25.3</i>		<i>498</i>
Amount remaining								
<i>Retirement</i>	(To be computed in Chapter 21)	<i>30</i>	<i>(5%)</i>	(To be computed in Chapter 21)			<i>5,000</i>	
Amount remaining								

^aRefer to compound interest Table A.

^bRefer to compound interest Table B.

^c\$2,000 minimum for each year. Additional annual college expenses are to be covered out of current income at that time.

Fig. 15-B. The Andersons' investment plan for achieving their goals.

Objective Questions

SAMPLE TEST QUESTIONS

Circle the letter of the correct answer to each question.

1. If you invested a lump sum of \$3,000 in a savings-type investment yielding 6 percent (annual rate), how much would the total investment be worth in 20 years?
 - a. \$4,800
 - b. \$6,600
 - c. \$9,600
 - d. \$110,400
2. If you invested a lump sum of \$3,000 in a mutual fund yielding an average of 10 percent compounded annually, approximately how much would the total investment be worth in 20 years?
 - a. \$9,000
 - b. \$20,100
 - c. \$23,120
 - d. \$171,900
3. If you invested \$1,000 every year in the stock market and achieved an 8 percent average annual compound return on your investments, approximately how much would you have accumulated in 30 years?
 - a. \$10,100
 - b. \$25,000
 - c. \$43,200
 - d. \$113,000
4. If you invested \$1,000 every year in a 6 percent insured investment, approximately how much would you have accumulated in 30 years?
 - a. \$5,700
 - b. \$31,800
 - c. \$79,000
 - d. \$84,000
5. If you invested a lump sum of \$1,000 in a 6 percent insured investment, took the interest payments by check, and spent them each year, how much would your total investment yield over a 20-year period?
 - a. \$1,200
 - b. \$3,200
 - c. \$36,800
 - d. \$56,000
6. The more uncertainty you have about the future of an investment, the greater the degree of risk you must assume with that investment.

True False
7. In general, the higher the rate of return offered by an investment, the greater the degree of risk you must assume in making such an investment.

True False

8. Which of the categories of investments listed below offers very low risk, a short liquidity time, and maturities ranging from 10 years on up?
 - a. Savings
 - b. Life insurance
 - c. Common stocks
 - d. Mutual funds
 - e. Personal real estate
9. Which of the categories of investments listed below offers a high rate of return, a short liquidity time, and some protection against stable inflation and also requires very little investment management?
 - a. Savings
 - b. Life insurance
 - c. Common stocks
 - d. Mutual funds
 - e. Real estate syndicate shares
10. Assume you have \$1,000 to invest toward something you really want. To achieve this goal you need about \$1,500 in five years. According to compound interest Table A, you would have to get an average annual rate of return of at least 8 percent (not adjusted for inflation). However, because of the urgency of the goal you are unwilling to take the accompanying risk. If the highest rate of return (and risk) you would accept would be a 5 percent insured investment, which of the following alternatives could you select and still reach your goal?
 - a. Invest about \$40 each year in the 5 percent investment, in addition to the initial \$1,000.
 - b. In addition to the \$1,000, make an extra initial investment of \$160 in the 5 percent investment.
 - c. Reduce the dollar amount of your goal to \$1,300.
 - d. Allow about eight years (instead of five years) to achieve your \$1,500 goal.
 - e. (All of the above)

Essay Questions

1. How does one institute a "frugality month" as a technique for saving money? What are the possible benefits?
2. You purchased ABZ corporation stock listed on the New York Stock Exchange, for \$10 a share. Over the subsequent months, the New York Stock Exchange index declined 10 percent. Also, the ABZ company had a serious fire in its main plant. You sold the stock for \$8 a share. Describe how each of these risks might have affected your investment loss, if at all: inflation, deflation, business, interest rate, market volatility, and liquidity.
3. Explain the two ways that you can reduce risk in investing.

Objective Answers

ANSWERS TO SAMPLE TEST QUESTIONS

1. c Multiply the factor of 3.2 (given in Table A for 20 years and 6 percent interest) by the \$3,000 you invested.
2. b Multiply the factor of 6.7 (given in Table A for 20 years and 10 percent annual rate of return) by the \$3,000 you invested.
3. d It may be surprising, but \$113,000 is the correct answer. Multiply the factor of 113 (given in Table B for 8 percent and 30 years) by the \$1,000 annual investment.
4. c Multiply the factor of 79.0 (given in Table B for 6 percent and 30 years) by the \$1,000 annual investment.
5. a There is no table giving the values of investments at simple interest (which is what is involved in this problem). In this case, you would receive a check for \$60 each year on your \$1,000 invested at 6 percent. In 20 years you would have received \$1,200 (60×20). Thus, your total investment would have brought you the \$1,200 and you would still have the original \$1,000.
6. T
7. T You would be foolish to take on a high-risk investment if you did not expect enough of a return on your money to make it worth the risk.
8. b Savings accounts have maturities shorter than 10 years.
9. d
10. e All four of the alternatives are possible choices. If the risk is too high you can either (1) invest more money, (2) reduce the dollar amount of the goal, or (3) invest the same amount for a longer period of time.

Essay Answers

1. Before each attempt to spend money, ask yourself the question "Do I *really* need to make this purchase?" The benefits are two: (1) you save money during frugality month, and (2) in reassessing your expense patterns from a new perspective, you may find permanent ways to save money on a regular basis.
2. The only two risks that are obvious influences in this example are market volatility (would explain a decline of roughly 10 percent from \$10 to \$9 assuming ABZ behaved like the NYSE average stock over those months) and business risk (the fire, which might explain the other \$1 drop to \$8). However, in real life more, if not all, of the risks would probably be interacting in a very complex fashion.
3. First, one needs knowledge and expertise in making investments. Second, one should diversify among investment media and also within each medium.

**APPENDIX
MATERIALS**

1. "12-Step Procedure for Planning Investments and Achieving Goals" (from the first and second editions of the text; includes Worksheet for Planning Investments and Achieving Goals)
2. "The Kondratieff Cycle: Investment Strategy Tool or Fascinating Coincidence?" by Ronald W. Kaiser

**TRANSPARENCY
MASTERS**

1. Worksheet for Planning Investments and Achieving Goals (blank form from text Figure 15-4, 11-step procedure)
2. Overview of Investment Types Treated in Chapters 16 through 20. These charts would probably be most effective as a review aid at the end of the unit.

12-Step Procedure for Planning Investments and Achieving Goals

APPENDIX

(From the first and second editions of the text; may be reproduced for classroom use)

You have learned some fundamental investment concepts, as well as how your hierarchy of investment goals may change—especially if you make more money. You should now be ready to learn the 12-step procedure for planning your investments and achieving your goals. If you never use such a procedure, you would have to be lucky to achieve your goals in the face of inflation, taxes, and the desire to spend your money today. You will not be able to apply this procedure fully until you have mastered the material in the remainder of this unit. However, a basic understanding of the procedure should make the entire unit more meaningful to you.

In Figure 15A-1 you will find the worksheet for this 12-step procedure.

Instructions

1. Look at your balance sheet and enter the total amount of your investment assets, less a reserve for emergencies (type I goal) in the blank under column H showing the amount of money on hand. Investment assets include all assets except personal property, home, and automobile.
2. Look at your income statement and budget plan and estimate the amount you will have available each year for investment toward goals. Enter this amount in the blank under column I showing the amount of money available.
3. Decide which goals are important to you and your family and enter them in column A. List them in order of your family's current priority of goals, starting with the most important goal.

Deciding which goals are really important is a step that too many people pass over lightly. If you do not sit down with your family and do some serious thinking about goals, several problems may arise. First, you may not adequately consider the emergency fund before you begin your investment program. Second, you may forget about a goal until it is too late to achieve the dollar amount required. Third, you may fail to understand the importance of the goal and therefore choose an inappropriate investment strategy for achieving it.
4. Estimate the amount of money needed (in today's dollars) to satisfy each goal, and enter the sums in the appropriate blanks of column B. Do not try to estimate the retirement sums needed as they will be discussed in Chapter 21.
5. Enter in Column C the number of years you have to achieve each goal.
6. Estimate the rate at which inflation will probably affect your goal amount and select the appropriate factor from compound interest Table A. While inflation has averaged about 4-1/4 percent since 1940, it has ranged from 0 to 11 percent. Of course, not all costs rise at the same rate. For example, college tuitions have risen more than three

Note: This appendix is from the first and second editions of the text; it may be reproduced for classroom use.

Name(s) _____								
Date _____								
WORKSHEET FOR PLANNING INVESTMENTS AND ACHIEVING GOALS								
A	B	C	D	E	F	G	H	I
Goal	Amount Needed	Years	Inflation Factor ^a	Adjusted Amount Needed (B × D)	Investment Medium	Average Yield (after tax)	Lump Sum Investment ^a (_____ on hand)	Annual Investment ^b (_____ available)
Amount remaining							_____	_____
Amount remaining							_____	_____
Amount remaining							_____	_____
Amount remaining							_____	_____
Amount remaining							_____	_____
Amount remaining							_____	_____

^aRefer to compound interest table A.^bRefer to compound interest table B.

Fig. 15A-1. Form to use for planning one's investments so as to achieve one's goals.

times as fast as the price of automobiles. To keep abreast of price trends and outlooks for specific items, you should read appropriate articles in the various news media.

7. *Multiply the inflation factor times the original amount needed to arrive at your adjusted amount needed (column E).*
8. *Select an investment medium appropriate to both the importance of each goal and the amount of time you have to achieve it. Write this in column F. Successful application of step 8 will become easier as you proceed through Unit IV and learn more about various types of investments.*
9. *Estimate an average total investment return (both income and capital gains) for each medium and enter this percentage yield in column G. See Table 15A-1 for ranges of returns you might expect from various investments. Use after-tax yields only. For example, if you are in a 40 percent bracket, a 10 percent total yield on a mutual fund would be only 8 percent after tax, using capital gains tax rates. Obviously, your actual results will vary from your projections but, for now, some projection is more useful than none.*

TABLE 15A-1
EXPECTED INVESTMENT RETURNS
FOR USE IN 12-STEP PROCEDURE

		Investment Medium	Lump Sum or Regular Investing or Both	Before-Tax Expected Return	Reduction for 30% Bracket	After-Tax Expected Return
Fixed Income—No Inflation Hedge	Life Insurance Savings Account or Savings Bond	Regular	Regular	3-5%	Often negligible	3-5%
		Both	Both	4-6%	1.2-1.8%	2.8-4.2%
	Municipal Bond (investment grade)	Lump sum	Lump sum	4.5-6%	None	4.5-6%
	Preferred Stock	Lump sum	Lump sum	7-9%	2.1-2.7%	4.9-6.3%
	Common Stock	Lump sum	Lump sum (could be regular but in large increments)	8-11%	2-2.5%	6.9%
	Mutual Funds	Both	Both	6-10%	1-2.5%	5-8.5%
	Real Estate Syndicates	Lump sum	Lump sum	10-15%	2-5%	8-13%

Note: This guide assumes average investment management and the continuation of trends for the past 10 to 20 years. Taxes assume full 30 percent rate on interest and dividends and an average of one-half of that rate on short- and long-term capital gains. Regular monthly or quarterly investing is not advised for lump-sum investments unless the regular amounts exceed \$1,000.

10. *If you plan to use a lump-sum investment to satisfy a given goal, select the appropriate factor from compound interest Table A. For example, for 10 years at 8 percent, the factor would be 2.2. Divide this factor into your adjusted need (column E) to arrive at the necessary lump sum. Enter this investment amount in column H and subtract it from the amount above it on your sheet of calculations to arrive at the lump-sum amount remaining for other purposes. Of course, this process is only an initial estimate. As time passes, you can see whether you are above or below your target and make adjustments.*
11. *If you plan to use an annual investment of a regular amount, select the appropriate factor from compound interest Table B. Continue this procedure as in step 10. Of course, as you will learn, some investments are more suitable for small periodic investments than others.*
12. *If you run out of investment funds (columns H and I) before your top priority goals are satisfied (and this will likely be the case if you are young), you have four alternatives: rearrange your budget to free up more money for investment purposes; look for higher yield investments on some goals; reduce the dollar amount for some goals; and increase the length of time allowed to achieve certain goals. After you have made one or more of these adjustments, go over the procedure again to see whether your revised plan will be successful in achieving your important goals.*

Do not be dismayed if, as a young family, you discover that none of the options in step 12 enables you to achieve all of your top priority goals. You may yet have a fifth option. This extra option is that your family income or assets may increase in several ways. As your career progresses, you may qualify for promotional raises in pay, which may give you extra income for achieving goals.

There is always the possibility that gifts or inheritances may increase your income. However, these should not be counted on, but should be considered windfalls and only allocated when actually received. As one or more of these items in the fifth option occurs, you can reapply the 12-step procedure.

Appropriateness of an Investment Medium

The appropriateness of an investment medium generally depends on three factors: your motives for saving and investing, your attitudes toward risk, and the actual advantages and disadvantages of each form of investment.

If you select a high risk, high return investment alternative to gain a much-needed goal and the investment goes bad, you may not reach your goal. Had you realized the importance of the goal, you might have invested the money in a lower risk investment. The opposite problem might arise if you invest your money at a low rate of return for a low-priority goal and thus divert too many dollars away from more important goals. Instead, you could invest fewer dollars at a higher rate of return. For example, you may be investing \$600 a year in whole life insurance (at a 4 percent return) for your retirement 30 years hence, when you might invest only \$300 in a mutual fund and

achieve the same results. Even if the investment is slow or erratic in certain years, you would be able to use the remaining \$300 a year to achieve goals that you currently consider more important.

Your values with regard to risk are something only you can decide. However, you should carefully consider the advantages and disadvantages of each form of investment. Consider how they pertain to your investment objectives before finally deciding on a particular investment. Only then will you know which investments suit your goals and what portion of your investment dollars should be put into each. You may decide that it is worth assuming a greater degree of risk to try for an annual rate of return of 10 to 12 percent.

The following three principles should be remembered whenever you try to select investment media to use to reach your goals.

1. The shorter the time you have to reach your goal, the higher the rate of return you must get to attain the goal or the greater the dollar amount you must invest.
2. The smaller your investments, the higher the rate of return you must get to reach your goals or the longer the time you must wait.
3. The higher the rate of return you seek, the greater the degree of risk you generally must assume.

by Ronald W. Kaiser

The Kondratieff Cycle:

Investment Strategy Tool or Fascinating Coincidence?

► In the 1920s the Russian economist Nicholas Kondratieff discovered a pattern of recurring 50-year megacycles in the economies of Germany, France, Great Britain, the United States and presocialist Russia. Each cycle is characterized by four distinct phases—(1) a growth period culminating in an inflationary peak, (2) a short-lived primary depression, (3) a plateau phase and (4) a long period of economic stagnation including a secondary depression.

The U.S. has experienced three complete Kondratieff cycles—from the 1780s to 1843, 1843 to 1896 and 1896 to 1940. The first phase of each cycle has lasted an average of 27 years, only to be followed by a one-year second phase—a primary depression. The third—plateau—phase, lasting four to eight years, has typically failed to regain the levels of growth that preceded the primary depression. The fourth phase—economic stagnation—has averaged 19 years and been characterized by at least one major secondary depression. On average, recessions during the stagnant phase have lasted a year longer than recessions during the growth phase.

M.I.T. professor Jay Forrester has concluded that the Kondratieff cycle can be explained by capital investment. During the growth phase, demand is imposed on the capital goods sector by both the consumer durables sector and the capital goods sector itself. At the peak, a labor shortage encourages capital intensive production, which puts even greater demands on the capital goods sector. The plateau phase fails to exploit the capacity created during the growth phase, while a relative reduction in labor costs, encouraging a shift back to greater use of labor, further diminishes the need for new capital goods. The stagnant phase is marked by a secondary depression and a rapid collapse of the capital goods sector. Accumulating physical depreciation then sets the stage for the next growth phase.

It appears that the U.S. is now in the midst of the third phase of a fourth cycle that began in 1940 and will

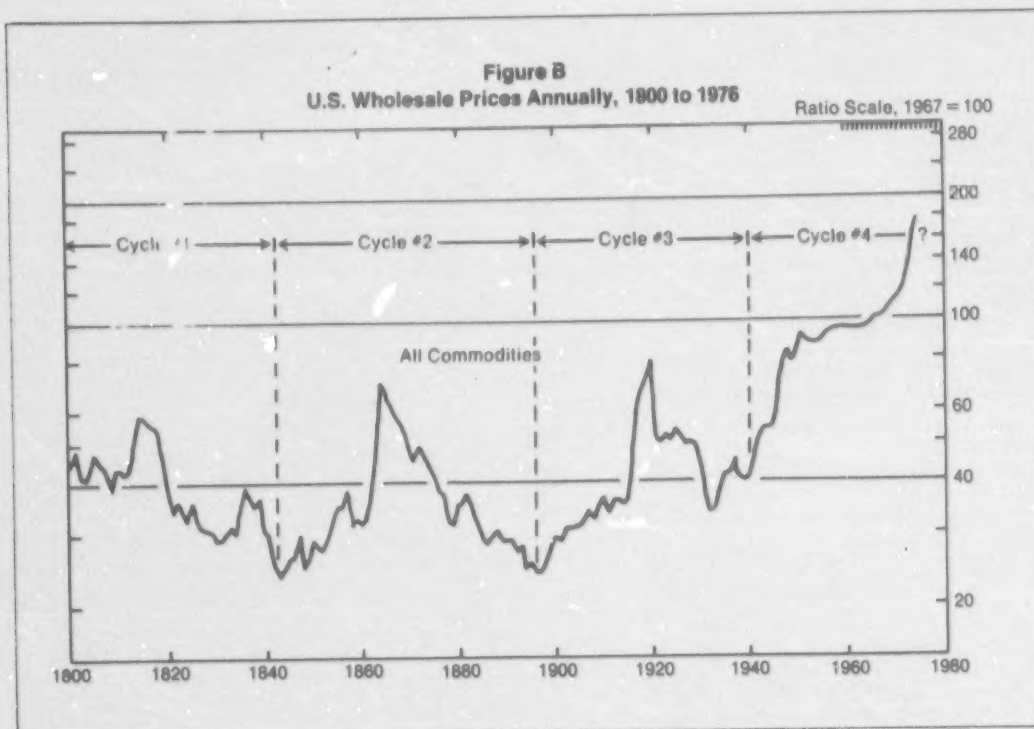
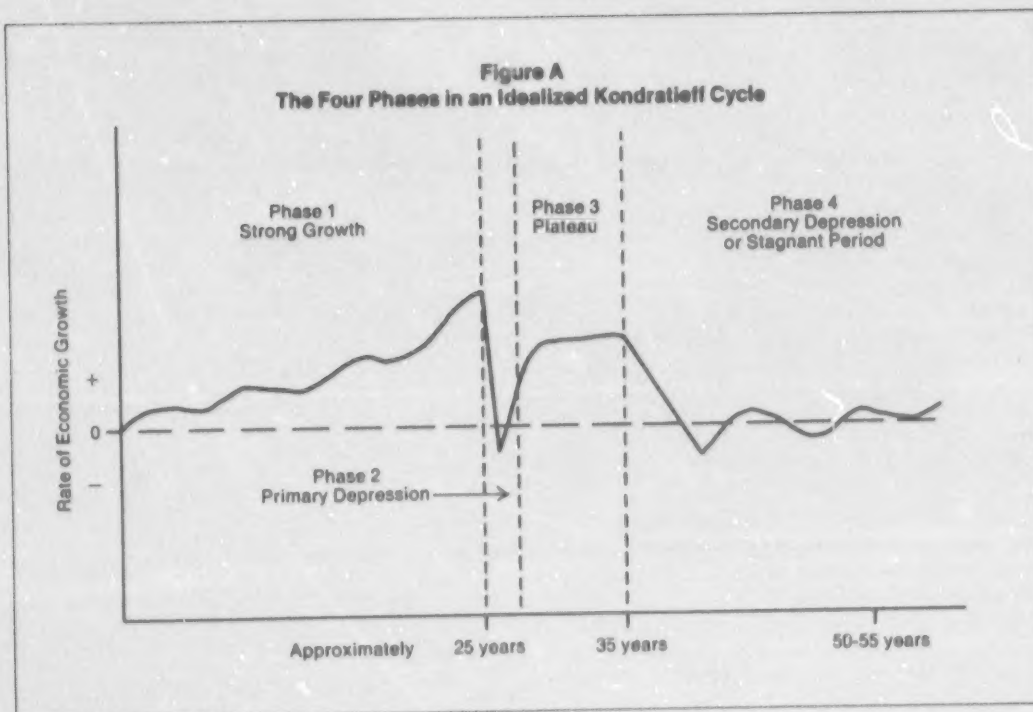
possibly end sometime in the 1990s. Investors who consider only the economic experience of the post World War II era may find they have been reading a dangerously short history book. ►

ECONOMISTS and money managers who consider only the experience of the post-World War II era may find they are reading a dangerously short history book. In the 1920s, Nicholas Kondratieff, a Russian economist, studied the history of wholesale prices in Western industrialized nations. He found that wholesale prices in Germany, France, Great Britain, the United States and presocialist Russia tended to peak at intervals of about 50 to 55 years.

Spurred by this finding, Kondratieff went on to discover a pattern of long-term economic cycles, called megacycles, which occurred nearly simultaneously in the five economies he studied. Each cycle is characterized by four distinct phases: (1) a long period of growth culminating in an inflationary peak, (2) a short-lived primary depression, (3) a plateau period and (4) a secondary depression (a long period of economic stagnation). These are illustrated in Figure A.

Because no one could at that time offer a sound theoretical explanation for these cycles, Kondratieff was largely ignored. We, too, were at first skeptical about the existence and influence of Kondratieff's cycles, especially in the context of contemporary economies. Economic conditions today are very different from what they were before the 1920s, one major difference being the influence of government on the economy. However, as we studied the available literature on megacycles, we became more and more

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convinced that knowledge of these cycles can be an important aid in designing portfolio management strategies.

Four Kondratieff Cycles in the United States¹

Figure B graphs the level of wholesale prices in the United States since 1800. In typical Kondratieff fashion, these prices have peaked every 50 to 55 years; the current peak is much higher than former ones and shows few signs of topping out. On the basis of this pattern, it appears that the U.S. has experienced three complete Kondratieff cycles—dating from the late 1780s to 1843, from 1843 to 1896 and from 1896 to 1940—and is now in the midst of the third phase of a fourth cycle spanning 1940 to 1990-95. (Because the wholesale price picture does not coincide exactly with the turning points in general economic activity, there is some dispute over the precise dates of each cycle; these discrepancies do not affect our analysis.)

Exhibit I breaks down each cycle into Kondratieff's four phases of economic activity. In the U.S., the first phase—strong economic growth—has lasted an average of 27 years and been followed by a one-year primary depression (or "deep recession," as the 1974-75 experience was euphemistically labeled, there being only nine per cent unemployment). The third—plateau—phase, lasting four to eight years, has been characterized by apparent prosperity that failed, however, to achieve the levels of growth that preceded the primary depression. The fourth phase—economic stagnation—has averaged 19 years and been characterized by at least one major secondary depression, the

Great Depression of 1930 being by far the worst, with over 20 per cent unemployment for one four-year period.

Exhibit II gives some relevant economic statistics for the peak and trough of each completed megacycle and for the apparent peak of the current cycle. Wholesale prices, as Figure B illustrated, closely coincide with Kondratieff cycle phases. Consumer prices and high-grade bond yields also tend to follow the phases of each megacycle; both went into a prolonged deflationary period following the peak of each of the first three megacycles. Thus far in the current cycle—if we define the inflationary peak as 1973—only long-term interest rates (Moody's AAA Corporate) have begun the characteristic decline, falling from a peak of 9.1 per cent to 7.9 per cent in 1977. However, their current rebound to near nine per cent is stronger than the similar interim recoveries in 1923 and 1929. And deflation of consumer prices has not yet occurred, although the rate of inflation may be declining gradually.

Common stock prices typically exhibit one major crash per megacycle. Their behavior during the third megacycle was particularly classic, in terms of megacycle phases:

Cycle Phase	Stock Cycle	Dow Jones Change
Growth Period	1896-1920	+313% (with five shorter cycles)
Primary Depression	1921-1922	- 46%
Plateau Period	1922-1929	+500% (with a 15% decline in 1923)
Secondary Depression	1929-1932	- 89%

EXHIBIT I: The Four Kondratieff Cycles in U.S. Economic History

Kondratieff Cycle Trough to Trough	Key Points in Economic Cycle			
	Strong Growth	Primary Depression	Plateau	Secondary Depression (Stagnant Phase)
#1 Late 1780s to 1843	Late 1780s to 1814	1815	1816-19 Era of Good Feeling	1819-43 Financial Panic of 1819 Panic of 1837
#2 1843 to 1896	1843-64	1866	1867-73 Reconstruction	1873-96 Panic of 1873-79 Railroad Prosperity of 1885-93 Depression of 1893-96
#3 1896 to 1940	1896-1920	1921	1922-29 The Roaring Twenties	1929-49 Crash of 1929 The Great Depression
#4 1940 to 1990 (?)	1940-73	1974-75	1975-? Stable Seventies?	?

The behavior of common stock prices during the first and second megacycles was less regular: The market crash in the first megacycle began 16 years (1835) after the start of the secondary depression (1819), while the crash in the second megacycle occurred 20 years early! However, in all three completed megacycles, the

plateau phase has been characterized by rising stock prices.¹

Megacycle phases have also tended to experience different levels of economic vigor. Recessions during stagnant phases typically last about a year longer than recessions during growth phases.

EXHIBIT II: U.S. Economic Statistics Marking the Peak and Subsequent Trough of Each Cycle

Kondratieff Cycle						
Trough	Peak	Wholesale Prices (1967 = 100)	Consumer Prices (1967 = 100)	High-Grade Bond Yields	Common Stock Prices*	
#1						
1780s	1814	59 (1814)	38 (1814)	7.7% (1816)	25 (1835)	
1843		24 (1843)	18 (1843)	4.3% (1821) 4.0% (1852)	Double Trough	6 (1842) Decline = 76%
#2						
1843	1864	67 (1864)	47 (1865)	6.7% (1861)	22 (1853)	
1896		25 (1897)	26 (1895)	3.2% (1899)	8 (1856)	
					Decline = 64%	
#3						
1896	1920	76 (1920)	59 (1920)	5.2% (1920)	390 (1929)	
1940		34 (1933)	39 (1933)	2.5% (1945)	41 (1932)	
					Decline = 89%	
#4						
1940	1973	Index	% Change	Index	% Change	
		1973 = 134.7	+15.4%	1973 = 133.1	+8.8%	9.1% (1974)
		1974 = 160.1	+20.9%	1974 = 147.7	+12.2%	
		1975 = 174.9	+4.2%	1975 = 161.2	+7.0%	
		1976 = 183.0	+4.6%	1976 = 170.5	+4.8%	
1990s (?)		1977 = 194.2	+6.1%	1977 = 181.5	+6.4%	
						Trough = ?
						? (Was it 1973-74, or is it yet to come?)

*Obtained by splicing several indexes together, with all related to Dow Jones Industrials for index uniformity. SRC Bicentennial Chart of Investment and Economic History, Securities Research Co., Boston, Massachusetts, 1976.

EXHIBIT III: Sociopolitical Events

Cycle	WARS OF EACH CYCLE		OTHER PARALLELS
	Previous Trough War	Peak War	
#1 1780s to 1843	War of Independence 1775-81	War of 1812 1812-15	1. Federalist Party accused of treason for protesting War of 1812; dies in election of 1816. U.S. has only one party for next term. 2. Westward expansion (1791-1819) culminating in overspeculation in Western land. 3. First secondary schools for women (1820s).
#2 1843 to 1896	Mexican War 1846-48	Civil War 1861-65	1. Johnson impeachment attempt (1868); no scandals. 2. Railroad overexpansion (1865-75). 3. Women's suffrage in Wyoming (1869).
#3 1896 to 1940	Spanish-American War 1898 (Philippine Intervention, 1899-1902)	World War I 1914-18 (Mexican Intervention, 1914-17)	1. Teapot Dome scandal (1921-1923); Harding died in office before prosecution. 2. Real estate construction boom (1920s) & Florida land boom (1925). 3. National Women's Suffrage (1920).
#4 1940 to 1990 (?)	World War II 1939-45 (Korean War 1951-53)	Vietnam War 1964-72	1. Watergate scandal; Nixon forced out of office (1974). 2. Real estate boom (1970s). 3. Equal Rights Amendment passed by Senate and sent out for ratification (1972).

The Sociopolitical Record

Exhibit III presents a brief review of U.S. history viewed in terms of Kondratieff cycles. It is startling to see how often the national mood paralleled the nation's position in the cycle. For one thing, all U.S. wars (except the Korean War, 1951-53) have coincided with either a peak or a trough. Peaks have also been characterized by political scandals, real estate booms and renewed interest in women's rights.

Two of the most furious political scandals of our nation's history—Watergate and Teapot Dome—coincided with the peaks of the third and fourth megacycles. The peak of the second cycle saw Congress' attempt to impeach President Andrew Johnson. During the peak of 1812, the Federalist Party was accused of treason for preferring to make war on France, rather than Britain, and failed to survive the next election.

Real estate booms are apparently initiated by the inflationary experience of peak years, but carry on into the plateau phase, with rental rates and real estate prices continuing to rise during the early years of otherwise deflationary price experience. We are in the midst of a real estate boom right now. The previous one, which included the Florida land boom of 1925, peaked in 1926 and climaxed with the building of the Empire State Building, a multi-year construction project completed in 1931. Prior to that era, we had the railroad overexpansion of 1865-75, which culminated in the depression of 1873-79—the worst on record to that point. The first recorded real estate boom came with the expansion westward over the Appalachians. As one eminent historian writes, "Many factors contributed to the catastrophe of 1819, but looming large among them was overspeculation in Western lands."¹

The current feminist movement has great strength, marked especially by the much debated Equal Rights Amendment, first approved by the U.S. Senate in 1972. The adoption of the constitutional amendment providing for women's suffrage, in 1920, coincided with the third cycle's peak. The peak of the second Kondratieff cycle was marked by Susan B. Anthony's suffragette movement and Wyoming's passage of a women's suffrage bill in 1869. That same era saw the establishment of women's colleges and women's admission to formerly all-male schools—an outgrowth of Emma Willard's pioneering endeavors in the establishment of women's secondary schools, which began during the peak of the first Kondratieff cycle. One period of the women's movement did not coincide with a megacycle peak. This period was marked by the National Women's Rights Convention held in Seneca Falls, New York, in 1848, which declared that men and women were equals—an unprecedented position.

Exhibit IV presents more evidence of the correlation between sociopolitical events and megacycles: Both

the amount and type of political activity (including legislation) vary with the phases of the megacycle. One might speculate that the growth phase of each megacycle is politically quiet because the country is enjoying new-found prosperity after having lived through previous trough and war. For example, as much as Harry Truman (in the growth period of the current megacycle) tried to continue with the New Deal in the form of the Fair Deal, the country would have none of it. His advocacy of national health plans, new TVA's, federal housing and the like largely failed to win Congressional acceptance.

The last decade of the growth phase, including the inflationary peak, has experienced the greatest sociopolitical activity. Perhaps this is because the long period of preceding growth results in a feeling that the country can afford to attack the perceived inequities of society. The most recent inflationary peak coincided with President Johnson's War on Poverty. Federal income taxation began during the third cycle's peak era (uniformly called the Progressive Era by historians). And the peak era of the 1860s saw such reforms as the emancipation of slaves and the establishment of tuition-free colleges.

The following plateau phase has generally been a politically quiet time, perhaps because of frustration and disillusionment with the prior decade's attempts at reform. Most political activity during the plateau phase represents labor and business attempts to deal with a less vigorous economy. Labor made itself felt in the post-Civil War plateau by forming the first national labor union, the Knights of Labor. In 1921 and 1924—the next plateau—labor acted to stem the tide of cheap foreign workers by greatly restricting immigration. Business (and labor) have also typically resorted to protective tariffs during plateau phases. The first U.S. protective tariff was passed during the initial plateau of 1816-19, and there was a substantial tariff increase in 1922. Today, we have quotas and "orderly marketing agreements."

Stagnant phases typically see the passage of measures designed (1) to salvage the dashed fortunes of the "little man"—e.g., the Land Act of 1820, Jacksonian democracy, the first Civil Service Law, the formation of the AFL and the enactment of Social Security, minimum wage laws and public housing measures; (2) to stimulate the economy—the Silver Purchase Act, the CCC and WPA and the formation of the TVA; or (3) to punish the "bad guys" popularly thought to have created the economic situation—the Sherman Anti-Trust Act, the National Labor Relations Act and the formation of the Securities and Exchange Commission.

Although there is certainly a strong correlation between U.S. sociopolitical events and the phases of U.S. Kondratieff cycles, it is difficult to say which is

cause and which effect, if indeed such a relation exists at all. Nevertheless, we can summarize several hypotheses:

1. Growth phases are politically quiet because, after the difficult times of the previous trough and war, the country is preoccupied with creating wealth and is pleased with the results.

2. The peak years of cycles are typically active because not everyone benefits equally from the growing national prosperity; the have-nots make their plight known, and the haves go along with various reforms out of feelings of sympathy and guilt.

3. Plateau phases are politically quiet because people have become frustrated and disillusioned with the preceding 10 years of reform and return to looking out for

EXHIBIT IV: Major Sociopolitical Changes in the Phases of Each Cycle

Cycle	Growth Phase Excluding Last Decade	Last Decade of Growth Phase & Primary Depression	Plateau Phase	Stagnant Phase
#1 1780s to 1843	1782-1804 -Bill of Rights (1791) -Alien & Sedition acts (1798)	1805-15 -Banned importation of slaves (1807)	1816-19 -First protective tariffs (1816)	1819-43 -Land Act of 1820 -Jacksonian Democracy (1828-42) (equal suffrage for males) -Tariff of Abominations (1824) (increase) -Anti-Slavery issues (1820) -Modern Democratic Party formed (1825)
#2 1843 to 1896	1843-55 -Free vs. slave states issues -Modern Republican Party formed (1854) -Tariff reduction of 1846	1856-65 -Homestead Act (1862) -College Land Act (1862) -National Banking System (1863) -Emancipation Proclamation (1863) -Tariff of 1857 (reduced) -Tariff of 1861 (increased)	1867-73 -Knights of Labor formed (1869) -Voting rights to blacks (1870) -Women's suffrage in Wyoming (1869)	1873-96 -Silver Purchase Act (1878) -Civil Rights Act (blacks) (1875) -Interstate Commerce Act (1887) -Sherman Anti-Trust Act (1890) -First Civil Service Law (1883) -McKinley Tariff Act (1890) -Silver Purchase Act (1890) -AFL formed (1881) -Wilson Tariff Act (1894) (reduced) -Immigration restricted (1882 & 85)
#3 1896 to 1940	1896-1910 -Dingley Tariff Act (1897) (increased) -Payne-Aldrich Tariff (1909) (reduced) -Currency Act (Free Silver) (1900) -Federal Railroad Regulation (1903) -FDA created (1906) -Dept. of Commerce & Labor created (1903)	1911-21 -Workmen's Compensation Act (1916) -Break up of Standard Oil (1911) -Federal Reserve Act (1913) -Income Tax enacted (1913) -Prohibition enacted (1919) -Women's Suffrage (1920) -Immigration limited (1921) -Clayton Anti-Trust Act (1914) -FTC created (1914) -Federal Farm Loan Act (1916) -Child Labor Law (1916) -Major tariff reduction & reform (1913)	1922-29 -Immigration limited (1924) -Fortney-McCumber Tariffs (1922) (big increase)	1929-40 -CCC (1933) - WPA (1935) -Prohibition repealed (1933) -Smoot-Hawley Tariff (1930) (big increase) -FDIC created (1933) -TVA created (1934) -Nat'l Industrial Recovery Act (1933) -Social Security enacted (1935) -Nat'l Labor Relations Act (1935) -Fair Labor Standards Act (1938) -Public Housing Act (1938) -SEC formed (1934) -FHA formed (1934) -Reconstruction Finance Corp. (1932) -Norris-LaGuardia Pro-Union Act (1932)
#4 1940 to ?	1940-63 -Full Employment Act (1946) -Taft-Hartley Act (1947) (restricted unions) -Civil Rights sit-ins begin (1960) -Trade Expansion Act (1962) (to reduce tariffs) -Dept. of HEW created (1953)	1964-75 -Federal Aid to Education (1965) -Medicare enacted (1965) -Voting Rights Act (1965) -Civil Rights Act (1964) -Voting Rights to 18-year-olds (1971) -Major race riots (1965 & 67) -Equal Rights Amendment passed by Senate (1972) -Pension Reform Act (ERISA) (1974) -Dept. of HUD created (1965) -Environmental Protection Agency formed (1970) -Occupational Safety & Health Act (1972) -Nat'l Rail Passenger System (1971)	1976-? -Dept. of Energy created (1977)	
TOTAL ITEMS IN COLUMN	16	32	7	30
ITEMS PER YEAR	0.23	0.71	0.35	0.49

Note: Names of acts were revised as needed to be more descriptive. Foreign policy issues are not included.

themselves. The actions typically taken by labor and business to protect themselves during these times result from the primary depression and presage the impending stagnant period.

4. Stagnant phases are politically active because their characteristically low profitability and high unemployment put pressure on the government to do something. The "something" involves wars and legislation.

5. Various types of aggression (wars and political scandals) and expansion (women's rights) occur at the peaks of megacycles because of the frustrations generated by the high level of economic activity.

6. The final "blow offs" of inflationary peaks result in real estate booms.

What Explains These Cycles?

Because the Kondratieff cycle is regarded skeptically, few economists have made any serious attempt to build a theoretical basis for its existence. However, recent work by Jay W. Forrester, an M.I.T. professor, concludes that the capital investment cycle can explain the Kondratieff wave.⁴

Forrester's hypothesis is based on an examination of the interrelationship between the capital equipment sector of the economy (spending for new public and private plant and equipment) and the consumer durables sector (spending for automobiles, refrigerators, etc.). Thus consumers order durable goods → durable goods manufacturers order new capacity → capital equipment makers build new capacity → capital equipment makers order new capital equipment to expand their own capacity → economic growth results in more consumer orders for durable goods, and further growth ensues as the cycle repeats.

By simulating these economic relationships in a computer model, Forrester found that a 50-year fluctuation is the natural result of (1) the lag time in orders, production rates and the movement of people and capital between sectors and (2) the need to develop excess capacity in order to catch up on deferred demand. Deferred demand results from the physical deterioration of capital stock occurring during the stagnant period. Deferred demand "catch up," plus the psychological and speculative forces arising from it, produce the peak in the waves. It then takes the country from 10 to 25 years (the stagnant phase) to use up and wear out the excess capital stock and begin the cycle over again.

According to Forrester, the growth phase of the Kondratieff cycle is the result of demand imposed on the capital goods sector by both the consumer durables sector and the capital goods sector itself. The peak phase is marked by an increase in wage rates and the development of a labor shortage that encourages capital intensive production, which puts even greater demand on the capital goods sector. This sector eventually expands to a capacity greater than that needed for

normal replacement and growth. Failure to exploit this capacity brings about the plateau phase of the cycle. Unemployment in the capital goods sector during this phase leads to falling wage rates, which encourage a shift back to greater use of labor, further diminishing the need for new capital goods. The stagnant phase sees a rapid collapse of the capital sector as the secondary depression begins. As demand falls, the excess capital stock slowly declines through physical depreciation, creating the conditions for the next cycle's growth phase.

Figures from our current megacycle indicate that Forrester's theory may have merit. Although post-World War II growth in the real capital stock has averaged 3.5 per cent per year, it accelerated to the four to five per cent range in the late 1960s. Since 1970, the growth rate has fallen back to two to three per cent.

Forrester also believes that government has much less ability to fine-tune the economy than it would like to believe. Although the government has been given credit for moderating business cycles since 1945, Forrester's computer model indicates that we should expect such cycles on the up-leg of the Kondratieff wave, while we should have weak expansions and protracted recessions on the down-leg, which is exactly what the experience has been.

Furthermore, the seriousness of the 1974-75 recession (primary depression) demonstrates the ineffectiveness of government and the power of the Kondratieff cycle. Forrester writes: "To the extent that monetary policy has any influence on the long wave, the principal effect may be to encourage upward overshoot at peaks with a corresponding steeper decline, as a consequence of expansionary monetary policy during the late stages of the long-wave economic boom."

As Exhibit V shows, each business cycle expansion of the recent growth phase has required proportionately greater increases in bank credit. As debt burdens increase, the Federal Reserve must increase the rate of growth in the money supply, both to service the prior debt and to provide for more growth. What this implies is that actual growth on the up-leg outruns long-term sustainable growth rates, thereby hastening the inevitable day when the level of economic activity will be insufficient to service the debt. This will trigger the bankruptcy of the most heavily levered corporations and individuals and bring about the secondary depression, or stagnant phase.

Our Hypothesis

We believe that human psychology and demographic trends, if they do not actually cause the megacycle, at least greatly reinforce the economic—especially monetary—mechanisms that move it. In particular, we suspect that each individual is deeply affected by the state of the economy during his adoles-

EXHIBIT V: New Credit Required For Each Expansion of the Recent Growth Period*

Month/Year Periods	Changes in Real GNP (Billions of 1958 Dollars)	Change in Real Bank Credit** (Billions of 1958 Dollars)	Bank Credit/GNP
6/49 - 6/53	+93.9	+26.4	0.28
6/54 - 6/57	+51.1	+18.6	0.36
3/58 - 3/60	+52.7	+18.3	0.35
12/60 - 12/65	+150.7	+96.5	0.64
12/66 - 12/68	+56.4	+64.2	1.14
6/70 - 12/73	+119.2	+153.9	1.29

*Modified from data in *Bank Credit Analyst*, June 1974, p. 26.

**All commercial banks — loans plus investments.

cent and early working or business years. Thus a person's influence on the economy, whether as a businessman, laborer, consumer, banker, voter or elected representative, is a lifelong reflection of his early experience.

People who entered the labor force during the Great Depression remained very conservative, preferring to pay off home mortgages early and buying everything with cash, not credit. This made for slow but steady economic growth during the 1940s and 1950s. But these people are now, by and large, retired or in the waning years of their influence on the national economic mood. Those who have had the greatest part in creating the current economic condition are their children, who grew up in the prosperous forties and fifties.

These people became the aggressive bankers who never made a bad loan, or the people who felt the government could outspend every problem, or the businessmen who felt that the company could grow faster simply by borrowing more money, or the union member who looked upon big business as an endless source of raises, or the consumer who embraced the plastic credit card, or the home buyer who didn't mind reaching for the third mortgage because "house prices always go up." As a result of this new mentality, we find ourselves the most heavily levered Americans ever. The ratio of bank loans to deposits hit a peak in 1973 of \$290 of loans for each \$100 of demand (checking) deposits—up from a 1944 low of \$30 per \$100. At the previous megacycle peak, in 1920, the ratio was \$140 per \$100, which, following the modest correction of the 1921 primary depression, went on to a \$150 per \$100 high in 1929. There is no doubt that our confidence in the government's ability to control the economy, founded on the Keynesian ideas of the 1930s, has made us far more vulnerable to economic shock than ever before.

Demographic trends appear to reinforce the impact of generational attitudes. Although historical census data are lacking, it is commonly believed that depressions (or stagnant phases) result in deferred marriages and reduced numbers of births, whereas peak eras result in baby booms because of the economic prosperity. Thus the number and corresponding influence of individuals who have grown up during a depression are relatively less than the number and influence of individuals whose formative years have corresponded to the up-leg of the growth phase. Population remains

weighted in favor of economic expansion and overexpansion of the type shown in Exhibit V until hard reality catches up.

Of course, a person's fundamental economic philosophy, formed early in life, can be modified by more recent traumatic experience. Current behavior reflects a new caution or conservatism arising out of the recent inflation and deep recession. On the other hand, older persons, with a better recollection of the 1930s, appear to be the most deeply affected; younger people are still more inclined to see the recession as incidental to ongoing prosperity and inflation.

In summary, while we cannot state definitely whether demographic and attitudinal trends cause the megacycle or merely reflect it, it seems possible that the cycle's 50 to 55-year periodicity corresponds to a two-generation cycle in which each generation, in reacting to the economic conditions created by its fathers, repeats the mistakes of its grandfathers.

Our Current Situation

The Kondratieff cycle explains some seemingly unusual events of recent years, including the worldwide inflationary peak of 1973-74, the unprecedented (post-war) severity of the 1975 recession, the buildup of liquidity and decline in long-term interest rates from 1974 to 1977 (and the likely resumption of that decline during the next recession in 1979 or 1980) and the continued failure to get back on the fast growth track of the 1960s and early 1970s. If we are indeed riding the Kondratieff wave, what are the signs that would indicate that we are now in the plateau phase, and how do these compare with our experience in the 1920s?

For one thing, there are signs that the inflationary peak may be subsiding. The 1920s saw an actual deflation. Thus far, we have seen declines generally only in farm prices and industrial raw materials (e.g., copper at \$0.68, versus its \$1.20 high in 1973). Long-term interest rates also appear to be declining, as one would expect from historical experience (see Exhibit II). This decline would be even greater except for one unusual source of demand for borrowed money: The federal government is borrowing enormous sums to finance its record budget deficits. Typically, plateau phases have federal budget surpluses.

Protectionism is rearing its ugly head again. Although government tries to avoid the term, we already have target prices for steel and orderly marketing agreements in color TV sets, shoes and sugar, as these

EXHIBIT VI: Farm Land Price Trends*

Year	Farm Land Price Index	Prices Received By Farmers Index	Prices Paid By Farmers Index
1912	22	99	101
1918	30	206 +108%	173 +71%
1920	40	211	214
1929	27	148 -67%	160 -49%
1933	16	70	109
1967	100	250 +95%	341 +93%
1976	244	488 -8%	657 +5%
1977	250	451	692

*Source: Commerce Department, *Handbook of Basic Economic Statistics*, November 1977.

excess capacity industries seek protection from foreign competition. Recent years have also seen numerous devaluations in an attempt to bolster exports (the United States, Great Britain, Mexico and Australia, for example). A *Wall Street Journal* headline of August 11, 1977, announced: "Global Commerce Spreads More Slowly As Barriers To It Spread." How different is this from the immigration quotas of 1921 and 1924, or the big tariff increase of 1922?

The economy has little need of new capital stock, whether in the private sector (as shown by the capacity index) or in the public sector. There probably isn't a medium-sized town in the country that doesn't sport a new city hall, park, police station, library or hospital. Menlo Park, a suburb of San Francisco, was so hard-pressed to find a place to spend federal job-creating funds that in 1977 it tore up perfectly good downtown sidewalks and replaced them with equally good sidewalks, modified with enough brickwork and planters so that the change could be labeled an "improvement." How can we keep up the capital spending pace of the 1960s? Yet anything less means a slower economy.

That old reliable indicator, the real estate boom, appears to be right on schedule. This boom has always been the last gasp of the inflationary peak, running its course in the plateau phase. Have you ever noticed how most of the grand old downtown hotels were built prior to 1929? Today, the Hyatt Regencies in several cities and the Bonaventure in Los Angeles are becoming the downtown architectural monuments of our cycle. Similarly, most of the big old movie theaters were built in the twenties. The entertainment monument of our era may prove to be the domed athletic stadium.

The biggest amount of current real estate activity, however, is at the man-on-the-street level. An August 16, 1977, UPI story told of 8,000 people showing up to buy 200 new homes in Orange County: "The end is not yet in sight" and "I haven't heard of anyone losing money on buying a house" were typical quotations. But prices are now surging to what is likely to become their peak. Real estate prices appear to decline about one to three years ahead of the secondary depression, with farm land prices, which are most closely tied to wholesale prices (farm product prices), leading the way. Exhibit VI illustrates how farm product prices have historically influenced farm land prices.

The mood of the nation also indicates that we are in a

plateau phase. People have become self-absorbed again. There is a nostalgia for the fifties. As the August 15, 1977, issue of *Time* magazine indicated, the country has grown tired of the reformist mood of the sixties. Jerry Rubin now lives in a Manhattan high-rise with uniformed doormen. Rennie Davis now sells life insurance for John Hancock, wears a blow-dry hairdo and lives, as he says, "a sweet useful life." High school and college students today are far more interested in good grades and careers than in hard drugs and protesting. The high school prom is once again a major social event, and college fraternities and sororities are making a comeback. In general, people are concerned with their own lives, and want Washington to stop interfering with them. California's Proposition 13 reflects this anti-government mood.

In the 1920s, it was much the same. The search for enjoyment and escapism found its outlet in the fantastic acceptance of the newborn Hollywood movie industry. People told Washington to mind its own business as they flagrantly violated Prohibition. The quickest way to wealth was the most admired and sought-after. In the 1920s, this meant the great game on Wall Street; today, it includes rock music stardom, "pet rock" promotions and the soaring salaries of professional athletes.

Finally, economists and bankers, businessmen, consumers, politicians, voters and taxpayers evidence a caution and conservatism that did not exist in the late sixties and early seventies. It will be impossible to regain the robust economy of that period without the accompanying aggressive attitudes.

Implications for Investment Policy

If history repeated itself exactly, the dyed-in-the-wool follower of Kondratieff would already be looking for actual declines in the level of wholesale and consumer prices. The real estate boom would cool off within the next two years, and prices would actually decline. Then, some time between 1979 and 1983, something would trigger the rapid collapse of our currently vulnerable economy, and we would suffer through one or more prolonged recessions, passing various sorts of legislation in an attempt to solve the resulting problems, until a war some time in the 1990s would signal the beginning of another 25 to 30-year period of sustained economic growth.

So far, one might conclude that the best investment policy would be (1) to stop investing in real estate and

take advantage of the current boom by selling all currently held property; (2) to sell out stock portfolios completely at the end of the plateau phase; (3) to take all those dollars from the sale of real estate and stocks and hold them in cash and AAA-rated bonds selling at a discount (thus taking advantage of the continued decline in interest rates); and (4) to wait for the secondary depression and use accumulated cash and bond resources to buy stocks and real estate cheaply. (You might ask why gold is not part of this scenario. The answer is that gold has historically declined in value in every deflationary phase of the Kondratieff cycle except the last one, when the government artificially pegged it at 69 per cent above its market value.)

But history rarely repeats itself exactly. Even if the basic cycle remains intact, its timing and its amplitude may change. History has always shown that no two cycles are exactly alike. For example, the stagnant period of the second cycle had such underlying strength from the industrial revolution then taking place that the period from 1871 to 1896 showed an average compound growth rate of 3.9 per cent in real GNP, higher than the 3.7 per cent 100-year (1871-1969) trendline rate. (However, even this period can be identified as a stagnant phase in that it experienced two very difficult, lengthy depressions and declining prices and interest rates.)

Our current megacycle differs from previous ones in the degree of government influence on the economy. Federal transfer payment programs alone (Social Security, unemployment compensation, welfare, etc.) equaled 11 per cent of GNP in 1977. Total net government outlays at all levels in the United States absorbed more than 30 per cent of our GNP, up from below 20 per cent in 1939 and under 10 per cent in 1929. While plateau phases have historically been periods of balanced budgets and accompanying deflation, as the country tried to repay its war debts, we currently have a very large budget deficit. Should it continue, it is conceivable that the stagnant phase of the current cycle will be accompanied by inflation—a new combination.

The current cycle may also turn out to be longer than earlier ones, because of our greatly increased life expectancy. This might mean that we have not yet seen the final peak, that the inflationary excesses yet to come may be greater than we have yet experienced, and that the 1975 recession was not the primary depression but only a more severe business cycle on the up-leg of the Kondratieff wave.

The incredible rate of technological change in the past 50 years could also alter expectations. The stimulus of a new technology may provide for continuous growth, rendering obsolete much of our capital stock before it can be physically used up. Such a period of growth during the stagnant phase of the cycle could parallel the experience of the industrial revolution in the late nineteenth century. On the other hand, it appears to be unlikely in the near future, since we have reduced our commitment to basic research over the past decade.³

With these caveats in mind, it is possible to make some recommendations for an investment policy designed on the Kondratieff megacycle. First, given the almost non-existent relation between the economic megacycle and any stock market cycle, equity investment decisions should continue to be based largely on independent considerations and the relative merits of alternative investments.

Second, although many money managers shunned corporate and municipal bonds when interest rates were rising during the 1960s, these instruments should be given more careful consideration during the years immediately after a Kondratieff peak. AAA-rated bonds, selling at a discount, offer the best insurance against a deflation or depression, so these assets should be given a relatively heavier weighting in the portfolio as one's forecast for a deflation becomes more certain. Bonds of less than AAA quality will probably not hold market value well in the event of a depression.

Finally, some real estate should be held as a hedge against the possibility of continued inflation. However, the portfolio should emphasize moderately mortgaged, long-term, stable holdings such as shopping centers and retirement mobile home parks. Properties in geographic areas that have seen excessive speculation, such as much of California, should be sold. (In 1929, according to a now retired mortgage executive who was a savings and loan branch manager at that time, single-family home prices in southern California fell 65 per cent on average.)

For the time being, however, the investor should monitor the economy and maintain a diversified portfolio biased in whatever direction he thinks appropriate. Persons who either use the Kondratieff cycle as an iron-clad philosophy or completely ignore it may end up being quite right, but they are more likely to end up looking very foolish. ■

Footnotes

1. We have relied upon federal data and other published sources, the reliability of which is obviously poor prior to the 1930s or 1940s. In many cases, indexes have been reconstructed from comparable data, and thus continuity is not perfect. However, it is the best we have to work with.
2. Although it is commonly believed that the Roaring Twenties—our last complete plateau phase—was a period of unusual prosperity, real GNP growth averaged only 3.5 per cent annually for 1923-29, compared to a four per cent real annual growth for 1947-69 and 4.2 per cent for 1896-1918. See U.S. Department of Commerce, *Historical Statistics of the United States—Bicentennial Edition* 1975, p. 224.
3. Thomas A. Bailey, *The American Pageant* (Lexington, MA: D.C. Heath & Co., 1966), p. 227.
4. Jay W. Forrester, "A New View of Business Cycle Dynamics," *The Journal of Portfolio Management*, Fall 1976, pp. 22-32.
5. "The Innovation Recession," *Time*, 2 October 1978, pp. 57-63.

16 · Fixed Dollar Investments

OBJECTIVES After studying this chapter, the students should be able to:

- Define *fixed dollar investment*.
- Explain the difference between nominal interest rate and effective interest rate.
- Describe the four methods of computing interest and how to select the best method.
- Give the four major reasons for investing in time deposits.
- Explain the advantages and disadvantages of fixed dollar investments in general.
- Describe the various types of fixed dollar investments offered by banks, savings and loans, thrift institutions, credit unions, and the federal government.
- Explain how money market mutual funds work.
- Explain how annuities work, their advantages and disadvantages as investments.

SUGGESTED APPROACH The following points should be emphasized in class discussion because they are usually not common knowledge.

- From an investment point of view, savings accounts should be used only for the following three reasons: as a repository for emergency funds, for accumulation of funds for short-term goals, or as a temporary or interim investment. People who use savings accounts as a long-term investment medium generally do so out of lack of knowledge about more profitable alternatives.
- Savings accounts usually do not offer any real return on an investment. You can use the following example from the text to illustrate this for your class.

6 % interest on savings account
<u>-2.4% taxes at 40 percent combined state and federal tax bracket</u>
3.6%
<u>-6.0% inflation</u>
-2.4% net loss in purchasing power

When you discuss this example in class, point out that a -2.4 percent yield may well be preferable to a -10 percent return in declining stock

markets. Savings accounts can be a relatively excellent interim investment in such a case.

- Yield is the only real difference to the investor between banks and insured savings and loans. Why not put your money in a savings and loan where it can get the highest yield?
- Daily interest can make a significant difference over some quarterly interest computation methods, especially FIFO.
- For the very conservative investor (those who may prefer cash value insurance, for example) U.S. savings bonds at 6.5 percent, with deferred federal tax and no state tax, may be an excellent medium for long-term objectives.
- Club accounts should never be used as a disciplinary crutch for savings, unless these accounts grant the same amount of interest as a passbook account at the same bank without any restrictions.
- Avoid uninsured thrift and loan institutions. One can get the same yield on money market mutual funds with much less risk.
- For those who are fortunate enough to belong to an insured or financially sound credit union, there may be no better alternative for your short-term savings—at least for the \$2,000 that qualifies for free life insurance.
- Money market mutual funds are an excellent vehicle for the budget technique whereby one saves money for major irregular outlays. The check-writing feature and high yield are what make this solution ideal.

The following technique for boosting yields on a bank passbook savings account from 5 percent to 5.86 percent can be offered as an interesting extra in class lecture. In order for this procedure to work, the account must have both daily interest computed from date of deposit to date of withdrawal and grace days. (Funds deposited by the tenth day of the quarter, for example, earn interest from the first of the quarter, and funds withdrawn within three days of the end of the quarter, for example, earn interest to the end of the quarter.)

1. Open two savings accounts at the same bank and always leave \$1 in each to keep them open.
2. Place your funds in one savings account and leave just \$1 in the other.
3. Switch funds from one account to the other at the beginning and end of the grace periods.

For example, three days before the quarter ends, withdraw all but \$1 from account #1 and deposit in account #2 the amount withdrawn. Ten days after the quarter starts, withdraw all but \$1 from account #2 and deposit in account #1 the amount withdrawn. Because of the grace periods, the computer will determine that the funds never left account #1. In the meantime account #2 is credited with 13 days' interest.

By using this method, savings can earn 13 days' extra interest each quarter for a total of 52 days, or one-seventh of a year's extra interest. With 5 percent interest compounded daily equal to 5.13 percent, one-seventh extra equals 0.73 percent extra yield, and 5.13 percent plus 0.73 percent equals 5.86 percent total yield. The only drawback to this technique would be if your bank were not located conveniently enough so that your extra interest would more than compensate for your extra costs in time, energy, and trans-

portation. (Most banks grudgingly allow savers to utilize this technique rather than lose the customer. Even at 5.86 percent, the institution can profitably loan funds at 10 or 13 percent.)

- SAMPLE CASES**
1. John sold a large amount of stock last June, producing a state and federal income tax liability of \$1,000,000, which pushed him into the highest marginal tax brackets. He reinvested the proceeds from the sale of the stock in a variety of investment media but put aside the \$1,000,000 of tax liability money into a money market mutual fund earning 9.8 percent. John figured the money would be safe and liquid when he wanted to pay taxes next April. Living in Hawaii, John was also aware that it took quite a while for any checks he wrote to clear mainland banks. Since the money market mutual fund John used cleared their checks through a New York City bank, John determined that it would take at least 14 days for the check to clear the New York bank and the \$1,000,000 to be deducted from his account. Therefore, John could pay his taxes on April 15 by writing a check on his money market fund for \$1,000,000 and yet collect interest on that \$1,000,000 for an additional 14 days. Since the annual interest on \$1,000,000 at 9.8 percent was \$98,000, that equated to a daily interest of \$268.49 ($\$98,000 \div 365$). Thus, he would earn \$3,758.86 on money that had already gone to pay taxes over that 14-day period; not a bad return on money that's not your own!
 2. Heather was concerned about interest rates. She knew that as interest rates rose, she should invest in short-term investments so as to ride up the yield curve. And, as interest rates plateaued and showed signs of declining, she should lock in interest rates and invest in more long-term maturing instruments. Currently, she was invested in money market mutual funds and the yields were quite high, almost 10 percent. She was wondering whether to convert her money market mutual fund to a four-year savings certificate at 7.75 percent to lock in a fairly high yield. When she talked to her financial advisor about this question, he pointed out the following:
 - The average maturity of the money market fund was one year.
 - As stated in the prospectus of the fund, the portfolio managers could buy instruments with maturities of up to four years if they so desired.
 - In the recession of 1974-75, when interest rates did plateau and then fall, the portfolio managers lengthened the maturity of the overall portfolio by rolling the shorter term issues into longer term ones, thereby locking in a high yield for an additional 12 to 10 months. And this yield was at all times higher than the certificate yields of the banks and savings and loans.Heather was impressed and decided to let the professional money managers call the interest rate cycle rather than herself. She stayed put where she was in her money market mutual funds.

1. Have your students get some literature from a local credit union and check on the interest yield available, the safety of investments made there, the minimum and maximum investments allowed, any extra insurance benefits available, and loan terms and conditions. Also, have them find out the source of the credit union's charter, and who operates the union on a daily basis.
2. Have your students find out what extra services savings and loan associations offer in your area in order to attract savers' dollars away from banks and each other. (Extra interest is often not enough.)
3. Write for a money market mutual fund prospectus to see how interest yields have fluctuated in recent years.
4. Have your students investigate the earnings rate on fixed annuities to see how the return compares with that of other fixed dollar investments.

ADDITIONAL MATERIALS AND ACTIVITIES

Invite a stockbroker to discuss fixed annuities and, in particular, income and estate tax benefits that accrue to such vehicles. Have him or her outline several situations in which fixed annuities are more appropriate from a standpoint of risk and yield than similar fixed dollar investments.

GUEST LECTURE IDEA

1. The valid reasons are:

- for use in emergencies
- for special goals due in the near future
- as a safe investment
- as a temporary or interim investment

For the investor who is aware of other low-risk investment alternatives with higher returns (AAA corporate bonds), the third reason rarely applies.

2. The principal differences between banks and savings and loans are as follows:

- The bank offers lower interest than the savings and loan.
- The bank is insured by FDIC; the savings and loan is insured by FSLIC.
- The bank pays interest, whereas the savings and loan may pay interest or dividends depending on the institution.
- The bank makes all types of loans; the savings and loan makes primarily mortgage loans.

The difference that has significance for the investor is that banks offer lower interest than do savings and loans.

3. The optimum situation for my savings would be daily interest.
4. U.S. savings bonds would be preferable to passbook accounts if:

ANSWERS TO CHAPTER QUESTIONS

- you wished to avoid state income taxes
- you wanted to take advantage of the deferral of federal taxes (Series EE bonds)
- your savings objectives were more than five years away
- your employer offered a payroll deduction plan for the bonds

The first condition might be overshadowed by daily compounding on a passbook account, particularly if one's state income tax bracket were very low.

5. These three features distinguish money market funds from other types of time deposits:

- variable interest
- lack of federal deposit insurance
- check-writing flexibility

6. Advantages of a credit union for a savings account: higher yield on deposits, payroll savings plans, free term life insurance, and good loan availability (usually with free loan protection insurance).

The factor to consider when opening an account with a credit union is the safety of your investment.

7. My net gain was \$81.60 (or 0.82%).

To find the dollar net gain:

$$\$10,000 \times .062 \text{ yield} = \$620 \text{ interest}$$

$$\$620 \times .32 \text{ tax bracket} = \$198.40 \text{ taxes}$$

$$\$620 - \$198.40 = \$421.60 \text{ after-tax interest}$$

$$\$10,000 \times .034 \text{ inflation} = \$340 \text{ loss of real purchasing power due to inflation}$$

$$\$421.60 - \$340 = \$81.60 \text{ net gain in real purchasing power}$$

To find the percentage net gain:

$$100\% \times 6.2\% \text{ yield} = 6.2\% \text{ interest}$$

$$6.2\% \times 32\% \text{ tax bracket} = 1.98\% \text{ taxes}$$

$$6.2\% - 1.98\% = 4.22\% \text{ after-tax interest}$$

$$100\% \times 3.4\% = 3.4\% \text{ loss of real purchasing power due to inflation}$$

$$4.22\% - 3.4\% = 0.82\% \text{ net gain in real purchasing power}$$

8. Probably the U.S. savings bonds would give Henry a larger lump sum in 13 years than the 6 percent savings account or the fixed annuity.

- The savings account would have only a 3.6 percent after-tax rate of return (6 percent less 2.4 percent for taxes in the 40 percent bracket).
- The return on the U.S. savings bonds (EE) would be tax deferred for 11 years 9 months, and he could roll the Series EE bonds into the Series HH to further defer the taxes until he needed the money at age 65. Also, they avoid any state taxes permanently. The compound rate of return would be 6.5 percent. Henry's tax bracket would probably be less than 40 percent when he retired at age 65.
- Based on the earnings rate of fixed annuities today, they are earning less than 6.5 percent. Even though annuities have the same tax deferral capability as savings bonds, the lump sum should be smaller.

9. The maturity date of an annuity is the date selected by the contract holder for monthly payments to begin. It is significant for two reasons:

- The further away the maturity date, the greater will be the lump sum at maturity if you make a simple premium payment or the less money you will have to invest each month for a certain level of benefits beginning at maturity.
 - You must select the settlement option you want by the maturity date.
10. The biggest disadvantage of fixed annuity investment programs is the low yield relative to other fixed dollar investments, such as money market mutual funds.

Student-Oriented Case Problems

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

1. Barbara could use a savings account in the following ways:

- To hold her \$1,000 summer savings (to be withdrawn as needed during the school year).
- To hold her father's \$1,000 check for the three weeks before the start of each quarter.
- To hold \$200 of the \$300 minimum balance she keeps in her checking account. (This would still leave her with a \$100 minimum checking account balance that will allow her to write checks without charge.)

The \$120 a month from the part-time job at school apparently was spent as it was earned since she had to draw down her summer savings as the year progressed.

Barbara probably does not need a true emergency fund since her parents take care of her basic needs. However, she ought to set aside some funds for a possible desired, but unexpected cash outlay. (This could be the \$200 from her checking account that she transfers to a savings account.)

Because of Barbara's erratic pattern of deposits and withdrawals, the savings and loan passbook account is best since it offers 5.5 percent interest from the day of deposit to the day of withdrawal.

The maximum amount Barbara could earn in interest (before taxes) each year is \$41.13.

The \$1,000 summer savings would be equal to a \$500 average balance over the nine-month period she is in school. (This assumes regular withdrawals in equal amounts.)

$$\frac{9}{12} \text{ year} \times 5.5\% \text{ interest} = 4.125\% \text{ interest for the nine-month period}$$

$$4.125\% \times \$500 \text{ average balance} = \$20.63 \text{ interest on summer savings}$$

The \$1,000 from her father (for tuition, room, and board) for three weeks, three times a year would be equal to \$1,000 invested for nine weeks.

$$\frac{9}{52} \text{ year} \times 5.5\% \text{ interest} = 0.95\% \text{ interest for the nine-week period}$$

$$0.95\% \times \$1,000 = \$9.50 \text{ interest on money from her father}$$

The \$200 transferred from her checking account would remain in her savings account all year.

$$\$200 \times 5.5\% \text{ interest} = \$11 \text{ interest for the year}$$

Barbara must decide whether this extra interest is worth the effort. The extra interest she would gain from her summer savings and from transferring \$200 to her savings account does seem worth the small amount of effort involved.

2. Keep \$700 in savings and \$300 in checking. He would save \$12.50 the first year by doing this.

Keeping \$1,000 in savings:

$$\$1,000 \times 5\% = \$50$$

$$\$50 \times 30\% \text{ tax bracket} = \$15 \text{ taxes}$$

$$\$50 - \$15 = \$35 \text{ after-tax interest}$$

$$\$35 - \$24 \text{ check charges} = \$12 \text{ net gain}$$

Keeping \$700 in savings and \$300 in checking:

$$\$700 \times 5\% = \$35$$

$$\$35 \times 30\% = \$10.50 \text{ taxes}$$

$$\$35 - \$10.50 - 0 \text{ check charges} = \$24.50 \text{ net gain}$$

Chuck and Nancy Anderson Selecting Their Savings Investments

1. Series EE savings bonds are probably the best investment for the Andersons' emergency fund.

The fact that interest is compounded annually is probably more than offset by the fact that there are no state income taxes due. Also, there may be an additional advantage if the Andersons don't need to cash in their bonds, but can wait until retirement when they will probably be in a lower federal income tax bracket.

The savings and loan one-year bonus account would be a better alternative if the Andersons expected to dip into the fund periodically. The credit union might also be a good alternative (assuming it is fairly safe) since the Andersons need life insurance and could probably get \$2,000 worth free from the credit union for their \$2,200 savings balance. This estimated \$7 premium savings would boost their effective yield on their savings by 0.3 percent (from 6 percent to 6.3 percent). On balance, the U.S. savings bonds would still be most attractive if the Andersons had a state income tax bracket of 6 percent or more (6 percent of 6% = 0.36%).

2. The credit union is probably the best place for the new car savings fund because the payroll deduction plan conveniently imposes the savings discipline necessary for success. (This is also a good place for the \$598 surplus as a result of using the 11-step procedure in Chapter 15.) The question of safety, however, should be seriously examined. Once the funds have been saved and the Andersons are out shopping for a car, the money should probably be transferred to a savings and loan 5.5 percent passbook account; if they withdrew funds from the credit union in the middle of a quarter they would probably not get any interest for that quarter.

The actual dollar differences of several alternate strategies in this case are not very great. Personal preferences would probably be the deciding factor. The only types of accounts we would not recommend would be bank passbook (low yield) and accounts requiring a lengthy holding period and/or too large a deposit.

**SAMPLE TEST
QUESTIONS**

Objective Questions

Circle the letter of the correct answer to each question.

1. Which of the following is NOT a time deposit investment?
 - a. Investment certificate
 - b. Club account
 - c. Common stock mutual fund
 - d. Money market mutual fund
2. The most federal insurance a married couple can get on their deposits in any one bank is \$40,000.

True False
3. The nominal, or stated, interest rate is lower than the effective interest rate, unless the interest is compounded annually.

True False
4. Which of the following methods of computing interest offers the highest return on your deposits?
 - a. LIFO, quarterly
 - b. Daily interest
 - c. Annual interest
 - d. FIFO, quarterly
5. Which of the following methods of computing interest yields the second highest return on your deposits?
 - a. LIFO, quarterly
 - b. Daily interest
 - c. Annual interest
 - d. FIFO, quarterly
6. Which of the following is NOT an advantage of time deposit investments?
 - a. High liquidity
 - b. Protection against inflation
 - c. Convenience
 - d. Security
7. Which of the following forms of time deposits has a tax advantage?
 - a. Savings and loan investment account
 - b. Money market mutual fund
 - c. Credit union shares
 - d. U.S. savings bonds (Series EE)
8. Savings and loan association dividends are the same as bank interest.

True False
9. Your bank checking account can be a form of time deposit investment if a minimum balance must be maintained to avoid check charges.

True False

10. A bank club account performs about the same function as setting aside a certain amount in your budget each month for some future purchase or expense.

True False

11. Fixed annuities have a return that fluctuates.

True False

Essay Questions

1. Which fixed dollar investment does the best job of fighting inflation? Is fighting inflation important with a fixed dollar investment?
2. Under what conditions would you buy Series EE bonds as opposed to Series HH bonds?
3. Which fixed dollar investment vehicle is most like Social Security? Why?

**ANSWERS TO
SAMPLE TEST
QUESTIONS**

Objective Answers

1. c Common stock mutual funds emphasize growth of principal, not interest income.
2. F The \$40,000 limit applies only to accounts with the same names or groups of names on them.
3. T
4. b Daily interest always yields the highest return.
5. a
6. c The principal is a fixed dollar amount and may decline in purchasing power during periods of inflation.
7. d You pay taxes on U.S. savings bonds only when you cash them in. Also, there are no state income taxes on such bonds.
8. F Bank interest is legally owed to you by the bank; savings and loan dividends are a distribution of earnings and are paid only as long as the association remains profitable. However, from a saver's point of view, this distinction is almost always purely academic.
9. T A dollar saved on check charges is equal to an after-tax dollar earned on a savings account.
10. T The only difference is that the amount set aside in your budget does not necessarily have to be kept in a separate bank account. (Refer to Chapter 4, "Budgeting," in the text if further clarification is needed.)
11. F The return is fixed; only variable annuities have returns that fluctuate.

Essay Answers

1. Money market mutual funds are the best at fighting inflation because they earn the highest interest rates of the day and, because of the staggered maturity of their portfolios, they can reinvest funds into higher yielding instruments, thereby boosting the overall yield of the portfolio, as inflation pushes interest rates higher.
Because fixed dollar investments are only appropriate for short-term goals, it isn't really that important that their yields keep pace with inflation because the money invested therein will shortly be consumed.
2. If you wanted to receive current income at 6.5 percent, you would buy Series HH bonds. On the other hand, if you wanted to accumulate a sum of money and defer either the receipt on this income or any income taxes, you would buy Series EE bonds. Theoretically, Series EE bonds would be a savings buildup while you worked and Series HH bonds would provide you money to live on when you retired.
3. Annuities are most like Social Security because they pay income for life and are built up over a long period of time (your working years).

17 · Stocks and Bonds

After studying this chapter, the students should be able to:

OBJECTIVES

- Define and explain the basic concepts of common stocks, preferred stocks, corporate bonds, and preferred bonds.
- Classify corporations by their basic characteristics of size, position in the industry, growth rate, dividend yield on stocks, and stability.
- Explain the basic factors that affect stock prices.
- Describe when the stock market would be an appropriate investment medium.
- Explain when it would be wise to invest in bonds and how such an investment should be made.

Since the concepts introduced in Chapter 17 are probably new to most students and full of terms with which they are not familiar, it is often useful for the instructor to go over the concepts and terms again in class. In our experience even adults who have invested in stocks tend to find these ideas difficult to grasp until they have been explained (sometimes more than once) in class.

SUGGESTED APPROACH

With regard to stocks, the following topics should be especially emphasized.

- Define earnings per share, P/E ratio, cash dividends, stock dividends, and stock splits. Be certain your students understand how cash dividends, stock dividends, and stock splits work and what effect each has on the investor.
- Explain the classifications of different types of stock. You can test their understanding of this by developing a list of hypothetical examples and having your students categorize them in class.
- Stress the fundamental principle that one should buy stocks for the right to corporate income. The discussion of the stock charts used in the Chuck and Nancy case study can be used to illustrate this point.

With regard to bonds, it is often useful to select some real examples out of a current copy of *Barrons* or the *Wall Street Journal* and compute their total return in class. Select several bonds, including some that are speculative and low-grade and have a total return in excess of 10 or 15 percent. Also, you can use a pair of bonds that are identical except for maturity date to illustrate the principle of built-in capital gains as the bond maturity date ap-

proaches. For example, using prices of June 18, 1979, GMA (General Motors Acceptance Corporation) 4-5/8s 82 was priced at 88 and GMA 4-5/8s 86 was priced at 77-3/8. Point out to your students that 82 and 86 are the years in which the bonds will mature; that 4-5/8 means 4-5/8 percent series; and that the prices are quoted as percentages of the face amount of \$1,000.

Also, be sure to point out that buying bonds at par value is particularly disadvantageous. The investor has downside price risk but has little upside appreciation potential because the bond would likely be called away.

SAMPLE CASES See the two cases in Chapter 18.

ADDITIONAL MATERIALS AND ACTIVITIES See this section of Chapter 18 for suggestions relating to stocks and bonds.

GUEST LECTURE IDEA There are usually one or two brokers in each local brokerage office who have developed a reputation for good stock market lectures. They use evening courses, at their office or often under the auspices of the community college, as a means of making some extra money and as a means of making contacts with potential brokerage customers. He or she may also be willing to make a guest appearance in your class. This person would probably be qualified to present any number of areas in stocks, bonds, or mutual funds that you may be uncomfortable with. If the speaker is unduly enthusiastic about a particular type of investment in the guest lecture, it would be worthwhile discussing with the students at your next class session whether a sales motive might have colored the speaker's enthusiasm.

1. The right to corporate income, whether in the form of cash dividends or retained earnings. (Voting rights usually carry no real benefit for the investor.)
2. The primary reason corporations issue common stock is to raise capital with which to begin or expand a business.
3. A cash dividend is a payment, in cash, of a company's profits. A stock dividend is an issue of new stock certificates (not payment of cash), generally equal to a percentage of the shares the stockholder already owns. A stock split, from an investor's viewpoint, is really not different from a large percentage stock dividend.
The cash dividend is most attractive to the investor because it is something of real value.
4.
 - a. The current P/E ratio on ABZ common is 22.5 ($\$90 \div \$4$)
 - b. Next year the company expects to earn \$9,000,000 ($2,000,000 \times \$4.50$) after taxes.
 - c. The current dividend yield is 2 percent ($\$1.80 \div \$90$).
 - d. If ABZ split three for one, the current EPS would be \$1.33 ($\$4 \div 3$).
 - e. I would call it a growth stock.

ANSWERS TO CHAPTER QUESTIONS

EPS is projected to grow at better than 10 percent, and this attractiveness seems confirmed by the relatively high P/E ratio of 22.5. Also, the 2 percent dividend yield is too low to call this an income stock.

5. My total percentage rate of return, before taxes, for the year is 18.9 percent.

$\$108 \times 11 \text{ shares} = \$1,188 \text{ total sale proceeds}$
 $\$1,188 - \$1,000 \text{ original cost of stock} = \$188 \text{ gain}$
 $\$188 + \$26 \text{ cash dividends} = \$214$
 $\$214 - \$25 \text{ commissions} = \$189 \text{ net before taxes}$
 $\$189 \div \$1,000 = 18.9 \text{ return}$

(To be pure, the cost basis for the divisor should probably be \$1,012 to include the commission cost, resulting in an 18.6 percent figure.)

6. The principal difference between a growth stock and ABZ corporation stock is the size of the company in terms of total annual sales; also important is the factor of industry dominance, which ABZ probably does not have.
7. An analysis of the fundamental outlook is necessary to determine whether today's P/E ratio for a stock adequately accounts for future expectations, and whether the stock is over- or underpriced. (The history of a stock's P/E ratio helps the investor arrive at the previous upper and lower limits on the P/E ratio for that particular stock.)
8. Corporate bonds are an appropriate investment for the investor with an important goal to achieve within three or four years, who is not willing to accept a high degree of risk on the accumulated capital, and does not wish to accept the highly taxable—and usually lower—6 to 8 percent yields on savings accounts.
9. $\$30 \div \$850 = 3.5\% \text{ interest yield}$
 $\$1,000 \div \$850 = \text{a factor of } 1.18$
 From compound interest Table A, five years and 1.18 produce a capital gain yield of about 3.3 percent. Total yield equals 6.8 percent (3.5% + 3.3%).

Student-Oriented Case Problem

At the end of Chapter 18 there is a comprehensive, relatively difficult, and time-consuming case covering the principles of both Chapters 17 and 18.

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

Chuck and Nancy Anderson Using Long-Term Stock Charts

The long-term stock charts were selected because they visually portray the P/E ratio, dividend yield, and EPS relationships discussed in this chapter. This case problem provides a good basis for discussing the fact that, to date, there are no mechanical techniques (such as point-and-figure charting, trend-line analysis, and the like) that, when applied to all NYSE stocks on a computer, produce a better performance than the NYSE averages. Hence, people who claim success with such a technique must apply, either consciously or

unconsciously, some form of "insight" in their stock selection and timing. The only reason for bringing the Securities Research Company's long-term stock charts to the student's attention is that they are useful if one wants to view the price-to-EPS relationship of a number of stocks in their historical context in order to determine quickly which of them warrant further study for their long-term prospects. Chart services that plot only price trends do not offer such an advantage.

Because the smallness of the charts as they are printed in the text might make it difficult for students with poor eyesight or poorly lighted study facilities to use them, we have included larger copies of all of them at the end of this chapter of the guide. If you wish, you can reproduce them for students who find the charts in the text too small for them to use comfortably.

When you assign this case problem to your class, you might point out for the benefit of those students without a background in mathematics that they shouldn't allow the fact that the charts are constructed on a logarithmic grid to confuse them. All this means is that a percentage change at one price shows up on the charts as being the same size as an equal percentage change at another price. For example, a 10 percent increase in the price of a \$10 stock shows up as the same size as a 10 percent increase in the price of a \$160 stock, even though the actual dollar amounts of these increases are very different.

The answers to the questions for the case problem are as follows.

1.	December 1968		March 1979	
	P/E ratio	Dividend Yield	P/E ratio	Dividend Yield
Sambo's Restaurants, Inc.	(not traded)		6	0.0%*
Northern States Power Co.	14	5.4%	7	8.7
Norfolk and Western R.R.	13	8.0	7	7.7
Carnation Co.	23	0.7	8	5.5
Warner-Lambert Co.	29	0.2	9	5.0
Eastman Kodak Co.	31	1.1	11	3.8

*Dividend omitted 2/26/79 per note on chart.

- Sambo's earnings have declined in recent quarters and the quarterly dividend has been cut to zero. The stock is at \$8-1/4, down from a high in 1977 of \$27.
- Norfolk and Western R.R. has current annual earnings of \$3.50 per share, the same as in 1967, with numerous ups and downs in between.
- Northern States Power. The dividend yield has risen from 4.4 percent in 1967 to 8.7 percent today, not because of soaring dividends (which have in fact risen), but because competition from rising interest rates in general has caused the stock price to decline. The earnings per share history and the "industry leadership" (a monopoly in its area, albeit regulated) makes this a mature growth stock.
- Eastman Kodak is near its all-time low P/E ratio (10 in 1978), yet the earnings and dividend payment trends are both up after a flat four years. The research question: might these trends continue?

6. Warner-Lambert and Carnation both have impressive earnings growth records but have considerable room to recover to even one-half their original high P/E ratios.
7. Given their aggressive, growth-oriented stance, I would select Eastman Kodak, Warner-Lambert, Carnation, and maybe Sambo's as a special situation. However, for reasons of diversification discussed in the next chapter, a stock such as Northern States Power could also be justified as some part of their holdings.

**SAMPLE TEST
QUESTIONS**

Objective Questions

Circle the letter of the correct answer to each question.

1. The most important thing investors should seek when they invest in common stock is the right to corporate income.
True False
2. The most important aspect investors have in mind when they invest in straight preferred stock is the prior right to assets in comparison to that of common stock.
True False
3. Since corporate bonds offer a fixed interest payment, you do not risk your invested principal.
True False
4. The primary way that investors benefit from the earnings of a fast-growing corporation is by receiving dividends.
True False
5. The primary reason that corporations issue common stock is to
 - a. provide the public with the opportunity to own a profit-making enterprise
 - b. provide an established valuation of the corporation for estate tax purposes
 - c. provide an established valuation for merger purposes
 - d. provide funds to the company to finance its operations and growth
6. If a common stock is selling for \$44 per share and is currently paying \$2 per share in annual dividends, what is the current dividend yield?
 - a. 4.54%
 - b. 5%
 - c. 22%
 - d. \$2
7. Which of the following is an advantage of investing in common stocks?
 - a. Hedge against deflation
 - b. Normal tax rate on dividends
 - c. High potential return on investment
 - d. Lower current income

Use the following description of a stock to answer questions 8 through 11.

Currently, ABZ common stock is selling at \$80 per share and is paying a dividend of \$2 per share. The current after-tax earnings per share is \$4. Next year the company is expected to earn \$5. The par value of the stock is \$10, and there are 1,000,000 shares outstanding.

8. What is the current P/E multiple on ABZ common?
 - a. 2
 - b. 8
 - c. 16
 - d. 20
 - e. 40

9. What is the P/E multiple, based on the expected earnings for next year?
- 2
 - 8
 - 16
 - 20
 - 40
10. How much did ABZ Corporation as a whole earn, after taxes, in the current year?
- \$2,000,000
 - \$4,000,000
 - \$5,000,000
 - \$10,000,000
11. If ABZ common stock had a two-for-one stock split, what would be the current earnings per share?
- \$1
 - \$2
 - \$4
 - \$8

Use the following list of fictitious common stocks to answer questions 12 through 14. (Figures in the chart are on a per-share basis.)

Stock	Dividends (\$)				Earnings (\$)				Current Price (\$)
	1976	1977	1978	1979	1976	1977	1978	1979	
Findyn	0.20	0.30	0.40	0.50	0.68	1.42	1.53	1.98	50
Simplex	0.00	0.00	0.00	0.10	-0.42	0.28	-0.91	1.04	31
City Power & Light	1.40	1.45	1.45	1.55	2.44	2.63	2.59	2.69	20

12. Which stock would you classify as a special situation stock?
- Findyn
 - Simplex
 - City Power & Light
13. Which stock might you classify as a growth or second-tier growth stock?
- Findyn
 - Simplex
 - City Power & Light
14. Which stock would you classify as a mature growth stock?
- Findyn
 - Simplex
 - City Power & Light
15. Assume you purchased 10 shares of ABZ common stock at the current market price of \$100 per share. During the next year you received a total of \$26 in dividends. Also during this time, you received a 10 per-

cent stock dividend. Exactly one year after the initial purchase, you sold all of your stock in ABZ Corporation for the going price of \$104 per share. Your total commissions for both buying and selling amounted to \$20. What was your total rate of return for that investment for the year, before taxes?

- a. 15%
- b. 10%
- c. 4.6%
- d. 0.6%
- e. -17.4%

Mathematical/Essay Questions

Use the following description to answer questions 1 through 3.

The Silly Corporation earned \$2 per share last year, paid \$1 in cash dividends, and its stock is currently selling for \$20. The company's board of directors declares a 10 percent stock dividend, but keeps the cash dividend the same.

1. What is the earnings per each new share?
2. If the P/E ratio stays the same, what is the new market price per share?
3. How else could the board achieve the one positive benefit on behalf of the stockholder?
4. What are the important differences between a growth stock and a second-tier growth stock?
5. The stock market has not had a good reputation as a place for investors to make money in the 1970s. Still, give two reasons why an investor might consider an investment in common stocks.
6. Compare preferred stocks as an investment (risk versus return) with common stocks and with bonds.
7. Which investment is probably preferable for an investor with \$8,000 to invest in a conservative investment: a 7 percent, 5-year savings and loan certificate or 10 AAA-rated corporate bonds selling for \$800 each, paying \$48 interest per year, maturing in four years?

Objective Answers

ANSWERS TO SAMPLE TEST QUESTIONS

1. T
2. F The investor is usually seeking a fixed income.
3. F If you hold a bond until maturity, the company will redeem it for its face value. In the interim, the market price of the bond may vary considerably, depending on general interest rate fluctuations. (There is also the inflation risk of reduced purchasing power.)
4. F The primary reason for buying the stock of a growth corporation is the expected higher level of its future earnings. Investors with these expectations may be willing to pay a higher price for the stock and thus drive its price up. The result for current stockholders is a capital gain. Besides, dividend payouts are usually very low because the company is reinvesting its profits in the growth of its operations.
5. d Although none of the answers listed is really incorrect, the best answer is that corporations issue stock to raise money. The other reasons are simply fringe benefits of such a stock issue.
6. a The dividend yield is simply the dollar amount of the dividend expressed as a percentage of the price of the stock. $\$2 \div \$44 =$ approximately 4.54 percent
7. c The other answers listed cannot be construed as advantages. Choice "a" is not even a characteristic of stocks.
8. d The current price of \$80 divided by the current per-share earnings of \$4 equals a P/E multiple of 20.
9. c The current price of \$80 divided by next year's estimated earnings of \$5 per share equals an estimated P/E multiple of 16.
10. b If the per-share earnings are \$4, and there are 1,000,000 shares outstanding, the company must have earned \$4,000,000.
11. b If ABZ stock were split two-for-one, there would be twice as many shares outstanding, or 2,000,000 shares. The company's total earnings of \$4,000,000 would remain unchanged, however. Therefore, the earnings per new share would be \$2 (one-half of the original amount).
12. c Simplex has a very unstable record of earnings and is currently selling for 30 times earnings. Given the company's past history, it is very difficult to say what will happen in the next few years.
13. a Findyn has established a dramatic 30 percent average annual growth in earnings, with no interim declines. Investors obviously recognize the potential of this company because it is currently priced at 25 times earnings. Also, note that the company has retained most of its profits in order to finance its continued growth.
14. d There are three reasons that City Power and Light might be con-

sidered a mature growth stock. First, because the product it sells is electric power, the company would probably experience little variability in sales even if the economy were to go into a moderate recession. Second, its historic growth in earnings per share has been less than 8 percent a year. Finally, since over half the earnings is paid out in dividends, there is little hope for above-average future growth.

15. a The total rate of return of 15 percent includes the total of all cash received minus the total amount of cash paid out.

10% stock dividend on 10 shares = 1 additional share
 11 shares of stock $\times$ \$104 price per share = \$1,144 on sale of stock
 $\$1,144 + \$20$ cash dividends = \$1,170 total cash received
 $\$1,170 - \$20$ commissions = \$1,150
 $\$1,150 - \$1,000$ original cost of 10 shares = \$150 net profit
 $\$150 \div \$1,000 = 15\%$ return on investment

Mathematical/Essay Answers

1. \$1.80 (a 10 percent reduction because there are 10 percent more shares.)
2. $10 \times \$1.80 = \$18$.
3. The one benefit was the increased cash dividend of \$1 per each new share. This could also have been achieved by increasing the old dividend payment to \$1.10 on each old share and not bothering with the stock dividend mess.
4. Second-tier are generally smaller and/or less well recognized by investors.
5. One, on a long-term basis, stocks offer high potential returns and a hedge against inflation. (In fact, the 1970s have made stocks historically relatively cheap.) Two, the \$100 dividend exclusion for income taxes (\$200 on a joint return) offers some good income tax advantages for the small investor.
6. They have much of the business and market risk of common stock without the growth potential due to corporate profit growth. They have the interest rate risk of bonds without the fixed redemption value and maturity date.
7. The bonds have a current yield of 6 percent, a yield to maturity of about 10 percent, and no penalty for each withdrawal.

18 · Buying and Selling Stocks and Bonds

After studying this chapter, the students should be able to:

OBJECTIVES

- Explain the functioning of the primary and secondary markets for securities.
- Explain how they would obtain the information they need for securities investing.
- Read and explain the meaning of newspaper stock price tables and the stock market averages.
- Explain how to select a stockbroker and utilize his or her services.
- Define and explain the basics of bull and bear markets.
- Describe how and when to use the basic types of stock market transactions—especially market, limit, and stop orders as well as odd lot transactions.
- Construct a diversified stock portfolio that will perform approximately as well as its beta would predict relative to the market indices.

The following five topics, complete with illustrations, should constitute the core of your lectures on this chapter. In addition, you may wish to use some of the optional topics listed in the section on additional materials and activities. (Louis Engel and Peter Wyckoff's book *How to Buy Stocks* (6th ed., Bantam, 1977) is quick reading and an excellent source of examples and stories to use in class.)

SUGGESTED APPROACH

1. *Primary and secondary markets.* We have found that the most effective treatment of primary and secondary markets is to develop a fictitious corporation and discuss in class the following phases in its development:

- Its beginnings as a closely held or family corporation.
- A primary offering to raise capital for corporate expansion. Point out that underpriced primary offerings seldom reach average investors; a primary offering that does is likely to be poor in quality and has therefore been avoided by large and sophisticated investors.
- OTC trading whereby brokers must phone around to match buy and sell orders.
- Making a market in the OTC when justified by brokerage house volume.
- NASDAQ trading in the OTC. (You no longer must phone around for the best price quote.)
- Listing on an organized exchange.

The last step should be amplified by discussing the workings of the floor of the NYSE, including the role of the specialist. Explain the routing of orders from a broker through house trader, phone on exchange floor, page, and call board to the floor broker (or sometimes to a floor broker who is not affiliated with any brokerage house—formerly known as a \$2 broker because that was the fee he used to charge), floor trading post, negotiation, floor clerk and quote board, and broker back to phone, brokerage house, and the broker who started the transaction. (Figure 18-1A may provide a useful background illustration for your discussion.) With regard to specialists, be sure to explain their two functions: (1) minimizing undue price gyrations—by buying stock for their own accounts when the sellers outnumber the buyers, and vice versa, and (2) matching stop and limit orders.

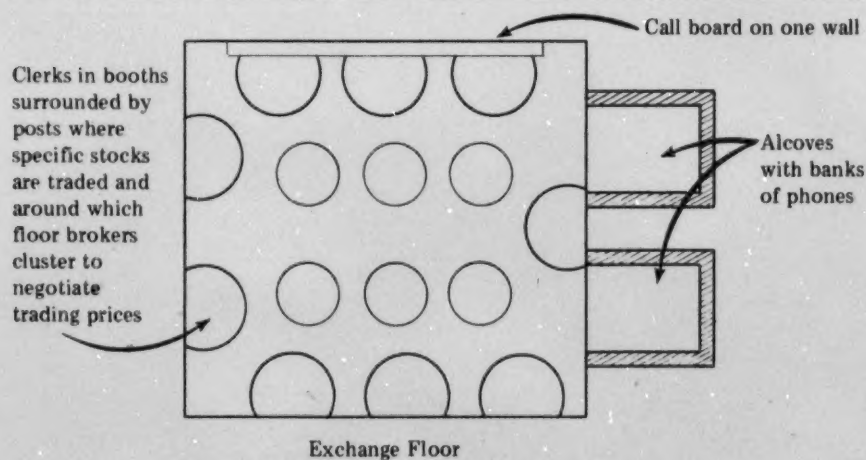


Fig. 18-1A The floor of an organized exchange.

2. *Brokerage houses.* In addition to discussing the various types of brokerage houses and the services they offer, the following two points should be covered.

- When selecting a broker, never take the first one the receptionist introduces; he or she is likely to be the youngest and most inexperienced of the group. Instead, ask for a five-minute appointment with the branch manager in order to request an introduction to a broker with at least three years' experience and a personal investment attitude that coincides with yours; say that you want to get the best advice concerning the strategies you will want to use (long-term buying, speculating, and the like).

When you meet the recommended broker, ask him or her as soon as possible, "What do you recommend?" A broker who responds immediately with specific recommendations may be interested only in selling stocks; but a broker who says, "Wait a minute. Let me try to learn a bit about your situation first!" is probably going to be of good service.

After you have taken these precautions, only time will tell. (One further key: to obtain good service, even with a small account, always be warm and friendly, even when the market is down. Your broker will love to work with you.)

- With regard to commissions, explain that the larger the trade, the smaller the percentage commission. Round-trip commissions should be under 4 percent total in order to improve profit potential.
3. *Types of stock purchase and sale orders.* Because these can be a source of continuing confusion to the novice in the stock market, be sure to cover each technique thoroughly in class. It will be helpful if you include in your lecture the development of numerical examples similar to those in the text. Place particular emphasis on market orders, limit orders, stop orders, buying on margin, and selling short. Point out the advantages and disadvantages of each—and stress the fact that there is usually little reason to use anything other than orders at-the-market. Table 18-A can be a useful blackboard illustration when discussing the pros and cons of selling short.

TABLE 18-A
COMPARISON OF POSSIBLE GAINS AND LOSSES
WHEN BUYING LONG AND SELLING SHORT

Technique	Maximum Gain Possible	Maximum Loss Possible
Buying Long (with long-term market trend)	No limit	100% of investment (plus margin, if used)
Selling Short (against long-term market trend)	100% of investment (plus margin amount)	No limit

4. *Diversified portfolio management.* Very few, if any, individuals regularly have insights into corporate prospects that are superior to the overall judgment of the market as reflected in the current prices of stocks. Therefore, a "stock-picker" approach (concentrating on a few stocks at a time) is likely to increase one's risk but not increase one's rate of return. That is, a small, nondiversified portfolio is likely to have greater volatility than the market averages, yet there is no strong reason to believe that the total return results will be superior. Instead, you should stress the following techniques to *reduce* risk while yet achieving one's return objectives:

- Select the average beta with which you are comfortable.
- Select the overall mix of income and capital gains that suits your objectives and tax bracket.
- Diversify by economic sector and by stock category to ensure a reasonable probability of achieving the objectives.
- Resist the temptation to actively trade the portfolio.

5. *Ten guidelines for stock market profits.* These can provide the basis for a full hour's discussion of sound market judgment. For each point, develop a fictitious example or ask a broker for entertaining, real stories to use.

SAMPLE CASES 1. As investment counselors, we have found two nearly foolproof indicators of major turns of the stock market, indicators that reflect the general mood of the public. One of them is the "cover story syndrome" of *Time*, *Business Week*, *Newsweek*, and other weekly magazines. After several disastrous months of a bear market, it becomes newsworthy. About the time the market is ready to turn, the story finally appears in the magazines as a cover story. Historically, when there is a bear on the cover, the market turns the corner within a month.

Similarly, once there is a bull on the cover, after several good up years in the stock market, the market is ready to turn and go down. The point is that once it becomes conventional wisdom most of the players are already in the game (bull markets) or out of the game (bear markets). If there are no new buyers to come into the game, the bull market is over; if there are no new sellers to come into the game, the bear market is over. Once the popular wisdom becomes widespread, it gets to be a cover story.

Another indicator we use is the investment counsel client indicator. It seems as though at every major market turn, whether the bottom of '74 or the top in '78, we find clients willing to make dramatic moves. At bottoms, we usually have one or two clients who just can't take the worry anymore, even if their portfolio is only half invested and the other half is in high yielding cash. They believe the half that is going down will go down forever, and within a month of the bottom, they finally panic and order us to sell everything. They quit and go to the sidelines. Often, the same clients or same kinds of clients will appear within a month of a bull market top. They finally get up their courage to invest fully back into the stock market. They see people making money in the stock market and they are ready to jump in with both feet. Again, they have let their emotions get the better of their reason.

2. This is a story about insider knowledge in the stock market. When I was a student at the Stanford Graduate School of Business, we had an investment club that met every Thursday. I was one of the officers in the club, and we would meet beforehand to plan what the investment club would discuss that week, and what stock we might buy or sell. At one planning session, the president of the club came excitedly saying, "Guess what, I've got a great tip for the club this week! It's Pioneer Natural Gas." This was back in the days when the stock market was a fun place to be, 1968.

He said, "My grandmother is on the board of directors of the company, and she told me that they are about to announce two major uranium finds." (This company was into some other sources of energy besides natural gas.) "So, I decided to buy the stock. I just bought it for \$38, and it's still only \$42. I think the club should buy some."

That was pretty exciting to get some insider knowledge, so I ran to the phone and talked to my broker about buying me 10 shares, all the money I had at the time. The broker, when he heard my story, said, "Hey, that sounds like a great idea. I think I'll do that too!" Of course, that was all the encouragement I needed and I went through with the transaction. Subsequently, the club also bought some shares. The next week was dead week, the week after that was finals week, and then we went away for spring vacation. During vacation I started picking up the

papers again and watching the stock columns. I noticed that Pioneer Natural Gas had dwindled from the \$42 that I had paid for it down to about \$29 a share, and I wondered what was going on. I kept scanning the pages of the *Wall Street Journal*, looking for the announcement of the uranium mines. Finally, I decided I'd better go to the brokerage office, look up this company in the Standard & Poor's sheets, and see what I had bought. The summary paragraph in bold type at the top of the first page said that Pioneer Natural Gas was looking for uranium mines, and that it was widely believed they had made two major discoveries and were in the process of proving them out. This would probably be confirmed shortly.

There it was for the whole world to see. It was not insider knowledge. I felt pretty foolish, particularly when I looked at the stock chart on the page and saw that the stock was normally a \$19 to \$22 utility stock that had, in the last six months, gone up as high as \$42. At that point, I decided it was time to sell the stock. I sold it, and a week later the announcement was confirmed back on page 14 of the *Wall Street Journal*. The news was out, but the stock market decided, "Ho, hum. We already knew about that after all." The stock settled back down to \$22 a share.

I later saw my friend in the halls of the business school and I said, testily, "You know, you didn't tell me when to sell the stock I bought, but when it just kept on going down, I finally sold it and lost money." He said, "Didn't I tell you? I found out that it wasn't a big deal after all, so I sold the shares that the club had. I forgot that you bought some, Ron. That's too bad."

That's another point about insider information. You might get the tip to buy, but you won't get a tip on when to sell.

The three basic lessons of this discussion are first, to investigate before you invest. Had I read the Standard & Poor's sheet, I wouldn't have made such a foolish decision. Second, always buy on the rumor and sell on the news. In this case, the rumor was already out and it was too late to buy. Once the news came out, of course, the stock was down. Third, don't take advice from somebody who is not prepared and responsibly motivated to give you advice when to sell.

The following may be added, at the discretion of the instructor, to the above lecture topics.

ADDITIONAL TOPICS FOR DISCUSSION

1. Reading stock price tables, although this should probably not have to be covered in class since it is adequately discussed in the text.
2. Some history of the SEC and the NASD could provide a useful academic background for why the securities markets are very different today from the free-wheeling, sometimes unethical markets of the 1920s.
3. Reading an annual report can be a valuable exercise if time permits. Review those available in the business school library and order a full class set of annual reports from a company of your choice. (Order these several weeks ahead of time from the public relations officer.) The following points should be included in class discussion.

- The first two pages often provide a general financial overview to allow the reader to get a feeling for the company.
- Then comes what we like to call the "flack" section, including the president's message, colored pictures, and nothing but good news. Skim quickly over this section since it is basically designed to keep the officers and board of directors in office.
- In your discussion of the balance sheet, be sure to emphasize the importance of using the following equation:

$$\frac{(\text{current assets}) - (\text{inventories})}{(\text{current liabilities})} \geq 1$$

- This calculation will help screen out financially shaky OTC stocks.
- When reviewing the income statement, be sure that you are looking at operating income only (i.e., exclude any extraordinary gains and losses). Also, be sure to use the fully diluted EPS in computing a P/E ratio.
- The section on sources and uses of funds provides an interesting overview of the flow of cash in a corporation. Point out how small cash dividend payments are in relation to total cash.
- In the footnotes you will find such adverse items as pending legal action by the Justice Department, and so forth. The independent auditors assume that the footnotes are an integral part of an annual report and that investors will read them. This is the only place the company can, so to speak, hide the bad news that must be considered in order for the investor to have a complete picture of a company's situation.
- The auditors' letter states their opinion as to the accuracy and consistency of the accounting methods used by the company. On rare occasions you may find an OTC company that insists on using its own biased accounting methods and assumes no one will heed the auditors' letter that points this out. (Some franchisers of the 1960s fall into this category.)

Brokerage houses frequently offer free booklets on how to read an annual report.

4. As an alternative to annual reports, carefully explain the S&P sheet on General Motors in Figure 18-6 of the text.

GUEST LECTURE IDEAS

1. Perhaps you know someone who has been reasonably successful in investing in the stock market. He or she might be a good guest lecturer if you can keep him or her from rambling from one story to the next. Instead, allot the person a few minutes to outline his or her basic approach. Then, have the person explain, with examples, his or her use (or disuse) of the ten guidelines for stock market investors. The whole presentation should take only 20 to 30 minutes at most.
2. See also the guest lecture ideas for Chapter 17.

ADDITIONAL MATERIALS AND ACTIVITIES

1. Have your students visit a local brokerage house. It would be easy to spend an interesting afternoon perusing the library materials, visiting with one of the brokers who had some spare time, learning how to read the quote board and use the telequote machine, and so on. Such casual visits can provide valuable insights into a fascinating realm of investments and will help your students get acquainted with many of the information sources listed in the text.
2. Have your students play the market on paper for the duration of the course. Have them start with \$10,000 and compete with friends, if possible. (One can gain sound judgment in the stock market only through actual experience.)
3. If your school is near one of the organized exchanges listed in the text, have your class pay it a visit. Appointments are not needed to view activities from the visitors' gallery or use the exchange's library materials. Be sure to go when the exchange is open for trading, usually 10:00 a.m. to 3:00 p.m. (EST).
4. Have your students read a Monday edition of the *Wall Street Journal*. They should take note of the stock price listings on the last few pages, including the OTC listings and the less well-known weekly OTC listings (Monday's copy only). They should also pay particular attention to the information relating to the various market averages on the second-to-last page. The *Wall Street Journal* also lists the stocks currently used in computing the Dow Jones averages, plus the current P/E ratio for them and other relevant information. (You might suggest that interested students buy a subscription to the *Journal* and begin reading the front page and the second-to-last page regularly.)
5. Have your students visit several brokerage houses and compare the quality of printed research available at each.
6. If possible, suggest that students develop and keep track of a portfolio, along the guidelines suggested in the text.
7. Research reports might be assigned on one or more of the following topics:
 - the history and development of present-day securities markets practices
 - the current controversy over the future role of exchange specialists
 - the development and present advantages of NASDAQ
 - the rules, ethics, and operating practices of the NYSE and ASE, the SEC, or the NASD
 - a critical comparison of the various market indices or averages
 - a comparison of two or more theories of why bull and bear markets occur and why they behave as they do

1. In the primary market the company is concerned with efficiently raising a sizable sum of money.
It is not involved in the sale of its stock on the secondary market.

ANSWERS TO CHAPTER QUESTIONS

In the secondary markets it would be concerned only with boosting the image it presents to investors and the public.

2. It has a greater chance of going broke because it does not have to meet the listing qualifications required by the ASE.
3. The most important factor to consider is the broker's method of investing for his or her own account.

That method is probably what he or she knows best.

4. I would give him a limit order at 33. He would send the order, via the trader and floor broker, to the specialist for his books. However, if the stock never got below 33, you would miss out on buying the stock.
5. The Dow Jones averages measure the price changes of blue chip stocks rather than the general market. (They are sometimes criticized for this.) The NYSE index records the average price and net change of all common stocks listed on the New York Stock Exchange.
6. An investor should have discretionary funds he or she can afford to lose, an aggressive personality, a strong disposition, considerable expertise and experience, and plenty of spare time for market activities.

Sell short if you "know" the stock will go down in price.

Buy on margin if you "know" the stock will go up in price.

7. A stop order should never be used in this way. The investor must always pay close attention to his or her investments.
8. I should hold the stock. The long-term loss deduction would save me \$1,000 in taxes.

The after-tax dollar loss between selling now and selling at \$70 in six months would be \$1,600.

If the stock recovers to \$70, you would realize \$2,000 in price appreciation, plus \$600 in tax savings the following year. Hold the stock.

9. The advantage of dollar cost averaging is that it forces investors to buy fewer shares of a particular stock when it is high priced than when it is low priced. It also forces them to buy more shares when the price is low instead of becoming depressed and selling.

The disadvantage is that, because you're regularly buying small amounts of stock, the commissions are relatively high.

Another disadvantage (not noted in the text) is that while the system tells the investor when—and how much—to buy, it doesn't tell him anything about when to sell and/or stop investing if the company does poorly.

10. I could find out corporate history and P/E ratio ranges for a listed stock by consulting the company's publications, the *Monthly Stock Digest*, *Moody's Handbook*, *Standard and Poor's Stock Guide*, and the *Value Line Investment Survey*.
11. Beta is a measure of the volatility of a stock (or of a stock portfolio) relative to the market averages. It is useful in constructing a portfolio that will be likely to meet one's risk tolerance and investment objectives.
12. A diversified stock portfolio reduces one's volatility risk by having representation in unrelated economic sectors and stock groups.

Student-Oriented Case Problems

1. The proportionate size of each holding is shown in Table 18-B.
2. The P/E ratio and dividend yield are shown in Table 18-B.

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

TABLE 18-B

Issue	Total Market Value	Proportionate Size	P/E Ratio	Dividend Yield
Mutual Life	\$ 4,500	6.9%	50	0
First Insurance	5,000	7.7	12.5	3.0%
Busy Stores	24,000	37.0	20	1.0
State Airlines	\$ 3,300	5.1%	22	0.9%
Major Oil	2,400	3.7	9.2	5.0
State Savings	2,000	3.1	20	0.5
Dynoresearch	\$ 1,600	2.5%	200	0
Bolt Textiles	6,000	9.2	15	4.2%
City Bank	3,600	5.5	12	2.8
Major Steel	\$ 2,500	3.8%	9.6	4.4%
Z Gas & Electric	2,500	3.8	12.5	5.2
Q Gas & Electric	900	1.4	12	5.6
N.Y. Mfg.	\$ 4,200	6.5%	30	0.95%
Multitron	2,400	3.7	100	0.04
TOTAL	\$64,900	100.0%		

3. The classification of each issue by stock category is:

Special Situation

Mutual Life (small company, no dividends)

State Airlines (could be cyclical; not mature growth because of low dividend yield)

State Savings (very small company)

Dynoresearch (very small company)

Multitron (low sales; high P/E)

Growth

First Insurance (large; fast growth; moderate P/E; could be second-tier growth)

Busy Stores (large; fast growth; high P/E)

N. Y. Mfg. (large; fast growth; high P/E)

Second-Tier Growth

Major Oil (large; fast growth; relatively low P/E; could be a growth stock if heavily owned by institutions and widely followed on Wall Street)

City Bank (large; fast growth; low P/E)

Mature Growth

Z Gas & Electric (regulated; slow growth)

Q Gas & Electric (regulated; slow growth)

Cyclical

Bolt Textiles (see earnings pattern; yet good P/E)

Major Steel (No company with \$800 million sales regularly gets 40 percent ESP growth; steel industry is classically cyclical.)

Note: Getting this answer all "correct" is not as important as applying your "yardsticks" consistently so that you maintain a diversified portfolio.

4. The diversification by economic sector is:

Distribution	37.0%
Finance	23.2%
Consumer manufacturing	15.7%
Nonconsumer manufacturing	10.0%
Energy	8.9%
Transportation	5.1%
Health and education	0
Mining	0
Services	0

The major flaws are: much too heavy a representation in distribution and finance stocks; too little representation in energy and nonconsumer manufacturing; no representation in health and education, mining, or services; and probably the biggest source of the lack of diversification lies in the 37 percent position in Busy Stores. Only consumer manufacturing and transportation are about right.

5. Health and education, mining, and services stocks should be bought. Also, some more mature growth stocks should probably be bought to reduce the risk level of Dad's portfolio.

Good candidates for selling are:

- a. More than half of the Busy Stores—it's a good stock, but there is too much.
 - b. Dynoresearch—it is too small and speculative for Dad's objectives.
 - c. State Savings and Mutual Life—these are also small and speculative, and Dad's portfolio already has too much in the finance group.
 - d. Multitron could also be a sale candidate. That P/E of 100 sounds pretty risky for Dad.
 - e. Students could also sell portions of other positions to get closer in line with the S&P 500.
6. Responses in the range of 0.9 to 1.2 can easily be justified. Lower than that implies an income-oriented, preservation-of-capital-type of account. Higher than that is probably too speculative for Dad, who is probably close to retirement.
7. Yes. When most stocks were selling near their all-time high P/E levels, it would certainly make sense to take some profits in some positions (or all, depending on the strength of your convictions), invest in a 6 percent savings account, and wait for better stock prices before re-investing.

8. I would select a firm with good research report services and a broker with a long-term growth philosophy for his own account.
9. I would consult Standard & Poor's sheets, *Value Line*, brokerage house reports, and the like.
10. Limit orders are generally unnecessary for this kind of portfolio. I would use stop orders if I went on vacation and would be away from the market or when my stocks are near P/E highs but still moving upward in price.
11. No.

**Chuck and Nancy Anderson
Their Securities Trading Account**

1. No. The Andersons do not have the time to stay in close enough touch with their investments to justify taking the high risk involved in maintaining a margin account.
2. No. They don't have enough time to study the market and keep a close enough watch over their investments.
3. A long-term approach utilizing fundamental analysis of the company and its historic P/E ratios seems most appropriate. An occasional contact with the market once or twice a month is not enough for them to be able to have the knowledge and timing necessary for short-term trading.
4. They should invest in two to four stocks. It would be physically impossible for them to buy five to seven different stocks, with a minimum investment of about \$1,000 in each, using only the small sum allocated by their 11-step procedure in Chapter 15. However, the Andersons should ask themselves if they really want to take that much risk just to have fun playing the market. Owning two to four stocks does not provide much diversification.

SAMPLE TEST **Objective Questions**
QUESTIONS

Circle the letter of the correct answer to each question.

1. The average industrial company in the over-the-counter market has a greater chance of going broke than does the average company listed on the American Stock Exchange.

True False

2. In order to buy stocks in the over-the-counter market, you have to go to your broker's office and pay cash.

True False

3. If you place a round lot order for a stock purchase, your transaction will always be completed within a few minutes after you give the order to your broker.

True False

4. You may sometimes get two different price quotations from two different brokers on an over-the-counter stock that is NOT listed on NASDAQ.

True False

5. The Dow Jones averages are the best indicators of the general trend of the stock market because they are the oldest and best established in investment circles.

True False

6. Stock brokers are sometimes referred to as

- a. registered representatives
- b. customer's brokers
- c. account executives
- d. (All of the above)

7. Which of the following should be most important to you when selecting a broker?

- a. Your banker's recommendation
- b. His or her investment attitude
- c. The size of the brokerage house he or she is with
- d. His or her willingness to take you to lunch

9. Recently, the price of ABZ stock has been fluctuating rapidly between \$34 and \$39 per share. Assume that you wanted to buy 10 shares of this stock, but did not want to spend more than about \$350 for them, before commissions. Which of the following orders would you give your broker?

- a. A limit order at 35
- b. A stop order at 35
- c. A stop-loss order at 35
- d. A market order

9. Assume that you owned 10 shares of ABZ stock, and that it has been gradually declining in price from a recent high of \$68 per share. Cur-

rently, the price is \$63 and you want to make sure that you take your profits at around \$60 per share at the lowest, just in case the price decline continues. Which of the following orders would you give your broker? (Include the effect of the odd-lot commission, if any.)

- a. A limit order at 60-1/8
 - b. A limit order at 60
 - c. A stop-loss order at 60
 - d. A stop-loss order at 60-1/8
10. It makes good sense to buy quality stocks when the market is low (as measured by the NYSE index) and to take your profits by selling those stocks after the market has gone through a sustained rise and investors are beginning to turn pessimistic again.
- True False
11. It makes good sense to sell short in bear markets and to buy long (with the use of margin) in bull markets, even if you don't have the time to keep a really close watch on your investments.
- True False
12. Your portfolio lacks representation in the distribution sector. Which stocks might you buy?
- a. Interstate Telephone Company
 - b. Amalgamated Chemical Works
 - c. Acme Markets
 - d. Tasty Hamburger Stands, Inc.
 - e. (Any of the above)
13. When predicting the average price volatility of a diversified stock portfolio, one should consider the
- a. efficient market theory
 - b. weighted average beta
 - c. average P/E ratio range
 - d. dividend yield

Essay Questions

1. What is the primary advantage of using a discount brokerage firm for handling your stock market transactions? List three services not offered by such a firm that would otherwise be available (sometimes at extra cost) from a conventional Wall Street firm.
2. Suppose that brokerage firms are generally experiencing financial difficulties. Why might you not want to hold your stocks in street name at such a time, even if the total value is under the \$100,000 of insurance provided by the Securities Investor Protection Corporation?
3. What three considerations are involved in controlling the risk in a stock market portfolio of 10 or more stocks?
4. After inheriting \$20,000, Dave decided to try to make some more money over the long term by investing it in the stock market, although he had

no previous experience with investing and knew little about the market. He interviewed two brokers. Broker A recommended he first take an evening series of lectures on the market, but, if he wanted to start investing, he suggested stocks like Sears, Texaco, General Electric, Texas Instruments, and Bank of America. Broker B recommended he invest in two over-the-counter stocks that had a good five-year EPS trend, had been moving up in price so far this year, and were soon to be written up in a recommendation by his brokerage firm. This could give Dave a quick profit. Which broker should Dave choose? Why?

Objective Answers

ANSWERS TO SAMPLE TEST QUESTIONS

1. T The listing requirements of the organized exchanges screen out all fly-by-night companies, and allow only established firms to be listed. The listing requirements of the NYSE are even more stringent.
2. F You purchase OTC stocks by telephone as you would other stocks, with payment due upon the delivery of the securities (usually five days after purchase).
3. F For small OTC stocks, your purchase will not be completed until a seller willing to sell at the current price is found. For some OTC stocks, you may wait hours or days. For most stocks, however, your trade is completed within a few minutes.
4. T Since there is no organized central location for non-NASDAQ OTC trading, there is no mechanism by which all buyers and sellers can agree upon a single market price at any given time.
5. F Since there are only 65 stocks listed in the total Dow, and only 30 stocks in the oft-quoted industrial average, there have been days when the bulk of the stocks on the NYSE have all gone up and the Dow has gone down, and vice versa.
6. d Usage of the various terms varies from brokerage house to brokerage house, depending on what is in vogue at the time.
7. b If your broker is a long-term investor, and you like to trade in and out of the market, he or she will be of little help as far as advice is concerned.
8. a A limit order at 35 would instruct your broker to buy 10 shares of ABZ for you at any time the stock dipped to \$35 or lower. You would never pay more than that price. If you take into account the odd-lot commission, you would have to set the order at $35\frac{1}{8}$.
9. d A stop-loss order at $60\frac{1}{8}$ would instruct your broker to sell your 10 shares of ABZ for the best price he could, whenever the stock dropped below $60\frac{1}{8}$, which is the odd-lot equivalent of 60. (You must add 12.5¢ per share to every odd-lot transaction.)
10. T Although this point seems terribly obvious, it is often difficult to maintain such rational thinking in the face of an emotion-packed market rise or decline.
11. F Selling short and buying long on margin are techniques that require both close daily scrutiny of your investments and the ability to take quick action when necessary.
12. c "a" and "b" are service companies, and "b" is nonconsumer manufacturing.
13. b Beta is the measure of volatility for a stock. When weighted by market value, it becomes a reasonable predictor of portfolio volatility.

Essay Answers

1. The primary advantage is a commission schedule that usually runs 30 percent to 60 percent below that of the typical Wall Street house. Three common services not offered by discounters would be (1) advice from the broker, (2) safekeeping of securities (along with collection of dividends for you, and so on), and (3) an open publications library, along with the firm's printed research recommendations.
2. At such a time, the economy and the stock market would probably also be in difficulty, and you might want to sell stock to defend against a possible loss. However, if your stocks were tied up in a defunct house, you would have to wait for SIPC to deliver your securities to you before you could sell them, perhaps weeks or months.
3. One, the average volatility (beta) selected by the investor indicates the market change risk. Two, diversification by stock category also keeps market risk to a minimum. Three, diversification by economic sector controls both business risk and market risk.
4. Broker A, for several reasons:
 - a. He advocates "investigate before you invest" by having Dave learn about the stock market.
 - b. He advocates "begin with quality" stocks, at least until Dave gains some experience.
 - c. He did not advocate the quick profit approach of broker B, which was contrary to Dave's long-term orientation.

19 • Mutual Funds and Other Professional Management

After studying this chapter, the students should be able to:

OBJECTIVES

- Explain how to determine when a mutual fund would be a good investment.
- Explain how to select the best group of mutual funds for a particular type of investment.
- Describe how to select the best mutual fund for a given objective.
- Explain the various types of savings, reinvestment, and withdrawal plans that are available with mutual funds and when each would be appropriate to use.
- Explain the general features of other sources of professional securities management—variable annuities, bank trust departments, and investment advisers.

Since this topic is fairly straightforward, and the key points are generally covered adequately by the text, there is little that needs saying here. The instructor should ensure that the class comprehends the following points, with emphasis on the open-end funds.

SUGGESTED APPROACH

1. The general concept of mutual funds, how net asset values are determined, and so forth.
2. The savings, reinvestment, and withdrawal plans that make mutual funds uniquely different from investing in stocks on one's own.
3. Mutual fund average performance is about equal to that of the stock market as a whole, less approximately 1 percent a year for asset management fees—largely because mutual funds cannot go to cash as much as they would like during declining markets.
 - Their holdings are too great for them to be able to sell quickly: the market wouldn't be available and such a sale, even if possible, would seriously affect the market price.
 - Mutual fund investors will hold on to a declining fund but tend to sell if it does not rebound quickly when the market turns around. (Its assets must remain fully invested for this to happen.)
4. Not all mutual funds with similar objectives perform the same. The investor must be discriminating. Past performance is usually a good indicator of future performance provided that the fund management has not changed hands and the fund's total assets have not increased dramatically (i.e., more than 50 percent) over the past year.

5. It is rarely desirable to buy a load fund and start off between 8 and 9 percent in the hole. There are no-load funds whose past record is as good as the best of the load funds for most types of investment objectives.

Note: This chapter on mutual funds takes a simplistic approach to mutual fund selection. A sophisticated analysis of a mutual fund would adjust the fund's past performance with the degree of risk taken to achieve those results. This is known as α (alpha) and β (beta) analysis. The superior investment manager, thus, is one who outperforms the market averages, when his risk level is adjusted to them. Unfortunately, to pursue such an interesting and useful topic would require an advanced course in investment finance. This note is simply to make instructors aware of the topic should they desire to pursue it on their own.

6. In discussing dual funds, you may want to use a numerical example to illustrate the concept of doubling the return. Assume that \$100 has been invested in the income shares and \$100 in the capital shares of a new dual fund.

If the \$200 is invested by the fund in common stock having a 4 percent dividend yield, there would be \$8 in dividends to the fund. With all these dividends belonging to the income shares, the yield would be 8 percent on that \$100 investment. If the dividends increased 10 percent, the return would be \$4.40 per \$100, or \$8.80 (8.8 percent) to the income shares.

If the stock were to appreciate 10 percent in value, there would be \$220 worth of stock. Subtracting the \$100 owed at maturity to the income shares leaves \$120 in value for the capital shares, for a 20 percent return. Similarly, a 10 percent drop in value to \$180 results in a 20 percent decline in the capital shares to \$80.

GUEST LECTURE IDEAS

1. Ask several brokerage firms for the name of a reputable local investment advisor. Invite one of the advisor's representatives to speak to your class about whether investment advisors are a truly different alternative to a mutual fund. (To the extent that advisors can take their clients to cash positions in down markets, they probably are different.) Also, have the person explain how their company operates, what personal services are offered, how their performance record compares to that of some good mutual funds, how advisory fees are charged, what stockbrokers they use, and how they do their investment research.
2. Have a stockbroker or mutual fund salesperson give his pitch to your class describing his favorite load fund and why an investor should utilize such an investment medium. After the talk, have the class analyze the presentation.

ADDITIONAL MATERIALS AND ACTIVITIES

1. Write to one or more of the no-load funds listed at the end of Chapter 19 in the text and request a set of prospectuses for your class. (The class lecture can be made more real and interesting if your students can refer to such an example.)

2. For those instructors teaching an adult night school class, there may be more than casual interest in professional investment management. As a focal point for discussion, you could reproduce the appendix at the end of this chapter (for classroom use only), an admittedly biased point of view designed to persuade clients to engage our firm's services.

ANSWERS TO CHAPTER QUESTIONS

1. Load funds charge an 8 to 9 percent front-end commission whereas no-load funds charge none. There may or may not be a small redemption fee charged by either type of fund. Asset management fees are charged by both types of funds. Sometimes a no-load fund will charge a slightly higher management fee to cover marketing costs; it generally takes from 10 to 20 years before this extra fee is equal to the front-end load of a load fund. (Note: performance results are computed after asset management fees are deducted, and so this is really not an issue.)
2. Mutual funds are appropriate for investors who do not want to manage their own stocks but do want to have the liquidity and long-term growth characteristic of stock market investments.
3. Stockbrokers generally handle only load funds because they make no commission on a no-load fund.

A good source of fund information would be one of the works listed in the bibliography for Chapter 19 of the text.

4. Special advantages of mutual funds include the following.
 - Periodic investment plans for small sums of money (with either no commissions or at least lower commissions than those on the NYSE monthly investment plan)
 - Automatic reinvestment plans
 - Systematic withdrawal plans
 - Broad diversification
 - Professional management
5. She should probably invest in a variable annuity. A mutual fund with even a low rate of systematic withdrawals could be a source of worry about depletion of funds in a severe bear market.
6. The size of a mutual fund might be a factor in my investment decision because funds generally (there may be exceptions) have certain characteristics that are in direct relation to their size.

Table 19-8 in the text provides a good picture of how the characteristics of mutual funds are related to their size.
7. The most important factor to consider when investing in a mutual fund is its past performance.
8. Closed-end investment companies are much like common stocks in that the market price may fluctuate above or below the net asset value, depending on the supply and demand. Also, the method of purchase and sale of closed-end funds is the same as for common stocks.
9. The newer fund has not yet displayed consistent ability. More importantly, a sizable infusion of new investor funds into the fund may cause it to grow to such an extent that its managers may have to use different

investment management techniques than the ones with which they had such success, and they may not be familiar enough with the new techniques to use them to advantage.

10. The similarities are that they both offer a fixed price at a set redemption date, plus current income. The differences are that a dual fund's income is in the form of dividends (which may fluctuate) and that the collateral is in the value of the securities at redemption date, not a corporate guarantee.

**ANSWERS AND
DISCUSSION
GUIDE FOR
CASE PROBLEMS**

Student-Oriented Case Problem

1. The approximate average compound returns for the funds are as follows:

Fund 1: 12%	Fund 5: 16%
Fund 2: 11%	Fund 6: 20+%
Fund 3: 20+%	Fund 7: 12%
Fund 4: 14%	Fund 8: 10%

Yes, these are definitely above average (which is about 8 to 10 percent).

2. In our opinion, fund 5 is the most appropriate selection for Jay. The management company, J. Jones, Inc., has the best record for the older, long-term growth funds listed. This indicates that its managers are competent at this type of investment management and are likely to continue to demonstrate this level of competence with fund 5. (Of course, competence with fund 4 over the long term does not guarantee similar competence with aggressive funds over the long term.) Also, its objective (aggressive) is appropriate for Jay, and it's not overly large in total assets—although it's not particularly small either. (Funds of about \$50 million would be preferred.)

The only possible alternatives, in our opinion, are funds 3 and 6. However, the drawbacks to fund 3 are the more average results shown by the Black & Co. management with its fund 2, which has been in business longer than fund 3 and is therefore a better indicator of their management expertise. Their results should be better than for growth funds over the same period since they have taken more risk than a growth fund. Also, fund 3 only stayed even in 1972 when most funds were up; this is not a good sign for an aggressive fund. Because of all this we would advise against fund 3.

Fund 6 may be a good selection, although W. W. Wilson is relatively new in the mutual fund business. Their results obviously should be better than those for fund 5 because fund 5 had to contend with the difficult stock market in 1970 when fund 6 was not yet in business. As a result of these considerations, we would conclude that, for Jay, a feasible (though uncertain) aggressive alternative to simply investing in fund 5 would be to invest in a combination of funds 5 and 6.

We would advise against funds 1, 4, 7, and 8 because they do not have appropriate investment objectives, and against fund 2 because it has done relatively poorly over its 10 years considering the risks it should have taken to accomplish its stated objectives.

3. He should check sources such as *Investment Companies* and *Johnson's Investment Company Charts*.
4. I would recommend that Jay wait three more months until he has saved the \$100. Meanwhile, he should put his funds in a 6 percent (daily interest) savings account.

Chuck and Nancy Anderson Case
Computing the Effective Return on a Mutual Fund

1. The figures that should be compared are those that assume all distributions are to be reinvested. The figures are \$48,512 for Growth Fund and \$53,260 for Dynamic Fund.
2. The effective compound rate of return for Growth Fund is close to 12 percent a year.

$$48,512 \div 10,000 = 4.85$$

A factor of 4.85 at 14 years represents a compound interest rate of almost 12 percent a year (Table A).

The effective annual compound rate of return for Dynamic Fund is a little over 10 percent.

$$53,260 \div 10,000 = 5.33$$

A factor of 5.33 at 17 years represents a compound interest rate of slightly better than 10 percent a year (Table A).

3. Growth Fund appears to be the better alternative for Chuck and Nancy, although the three-year difference in starting dates may have some effect on the results.
 As one final check, Chuck and Nancy should compare results over the most recent five-year period to see whether one fund still shows superior returns over the others.
4. No. The stock market period from 1974 to 1979 is not necessarily comparable to the period from 1962 to 1979.
5. Sources they could use include *Investment Companies* and *Johnson's Investment Company Charts*.

Both calculate results from comparable starting dates. (See the bibliography for Chapter 19 in the text.)

SAMPLE TEST **Objective Questions**
QUESTIONS

Circle the letter of the correct answer to each question.

1. Mutual funds are another means of investing in the stock market.
True False
2. All mutual funds give about the same results.
True False
3. Mutual funds spread their investments over 30 to 50 (or more) different stocks and bonds.
True False
4. Income tax considerations are not important in choosing between an open-end mutual fund and a variable annuity.
True False
5. Your stockbroker can offer a complete list of mutual funds to choose from, plus complete information about each.
True False
6. Dual fund income shares might be called an "inflation-hedged bond."
True False
7. Registration with the SEC assures competence on the part of a professional investment advisor.
True False
8. The total size of a mutual fund is not an important consideration when deciding which one to invest in.
True False
9. You might invest in a bond fund or a preferred stock fund if you wanted current income from your investment.
True False
10. Diversified common stock funds keep all excess cash as cash on hand; they do not have time to worry about bonds or certificates of deposit.
True False
11. Which of the following is NOT a benefit of investing in mutual funds?
 - a. Spreading risk over several investments
 - b. Hedge against inflation
 - c. Chance for above-average investment return
 - d. Participation through stock voting rights
 - e. Professional portfolio management
12. Which of the following is likely to be an advantage of investing in a closed-end investment company?
 - a. Low sales commission
 - b. Automatic reinvestment plans
 - c. Size limit
 - d. Set market price

13. Diversified common stock funds usually invest in
- 10 to 20 different stocks
 - 3 to 40 percent corporate and government bonds as a hedge
 - only those industries that the management knows well
 - around 50 or more different common stocks
 - no convertible securities
14. Which of the following is NOT a type of mutual fund?
- Open-end load fund
 - Closed-end load fund
 - Open-end no-load fund
 - Closed-end with only standard broker's commission
15. Which of the following is NOT a financial benefit from an open-end mutual fund investment?
- A three-for-two stock split
 - Cash dividends
 - Cash payments from capital gains
 - Increase in share value
 - Lower capital gains rates on some of your income
16. Which of the following is NOT a consideration in choosing a mutual fund?
- The fund's investment goals
 - Commission costs
 - Experience of the fund's management
 - The past record of the fund
 - The presentation by the fund salesperson
17. Which of the following would have given you the best investment return over the past 10 to 20 years?
- Investing in an average mutual fund, and taking all capital gains and dividends in cash and putting them in a savings and loan account
 - Investing on your own in stocks that grew at the rate of the New York Stock Exchange index, and reinvesting all dividends and realized capital gains
 - Putting your whole investment in a savings and loan or bank account

Essay Questions

1. Give three reasons why mutual funds should be given serious consideration, in spite of their poor performance record in the 1970s.
2. Which two parameters must be comparable in order to make a reasonably valid comparison between the performance of two mutual funds?

**ANSWERS TO
SAMPLE TEST
QUESTIONS**

Objective Answers

1. T Most mutual funds invest a majority of their assets in common stocks.
2. F Look at the most recent issue of any mutual fund comparison service to see how different the records of many funds are.
3. T This is one of the purposes of mutual funds.
4. F Mutual funds are taxed at capital gains rates on gains and ordinary income rates on dividends, while all profits from variable annuities are tax deferred until paid out, when they are taxed at ordinary rates.
5. F Although your broker will probably have all the information you need about the load funds, he or she may lack much information about the no-load funds.
6. T In the past, dividend payouts have grown with inflation.
7. F Competence can only be discerned through research on the part of the investor.
8. F Large mutual funds may be inappropriate for the aggressive investor. Small mutual funds may be inappropriate for the conservative investor.
9. T You could also use the systematic withdrawal plan offered by many open-end common stock mutual funds.
10. F Most funds keep most of their excess cash in short-term corporate and government debt issues.
11. d The fund's managers retain the voting rights in the corporate stock the fund owns.
12. c Since closed-end funds have only a fixed number of shares outstanding, its managers cannot be overwhelmed after a very successful year; a flood of dollars cannot come pouring in from an eager investor public.
13. d Although "c" is a possible answer, most diversified funds try not to restrict themselves to particular groups of industries. They try to spread the risk over many different stocks in many different industries.
14. b Closed-end funds are not sold with a front-end load; they are sold like regular common stocks.
15. a Since mutual fund shares are priced at net asset value and since fractional shares can be bought and sold, there is no real financial benefit from a split of mutual fund shares.
16. e The persuasiveness of the fund salesperson should not sway the investor's evaluation of the other four factors listed.
17. b Average mutual funds have underperformed the market in the past probably because of their management fees. This would certainly be the case if the investor did not reinvest the dividends and capital gains distributions in the mutual fund.

Essay Answers

1. Among the possible good answers are the following:
 - They offer broad diversification, which would not be possible on one's own.
 - Professional management saves time, worry, possibly costly mistakes.
 - The poor performance of the 1970s may well have created good investment values for the 1980s.
 - Accumulation plans help foster a savings habit.
 - You can easily match your investment goals with the stated goals of the appropriate mutual fund.
2. The investment objectives and the beginning and ending dates must be comparable.

"What You Should Know before Selecting a Personal Money Manager" (a discussion distributed to potential clients of Bailard, Biehl & Kaiser, Inc.)

APPENDIX MATERIAL

WHAT YOU SHOULD KNOW BEFORE SELECTING A PERSONAL MONEY MANAGER

In recent years, several events have conspired to make the process of managing your personal finances more difficult.

1. The world economies have become more closely intertwined. The financial condition of a far away country such as Zaire may affect the condition of financial institutions and opportunities you deal with at home.
2. The federal government has demonstrated a poor ability to deal consistently and effectively with economic problems such as inflation, recession, unemployment, etc.
3. In an effort to close certain tax "loopholes", Congress has reformed our tax laws to the point that few people understand them.
4. Intense competition among purveyors of various financial products has resulted in an ever increasing number of alternatives.

Identifying financial products, services, and opportunities appropriate for you in these complex and constantly changing times has become a challenging proposition. Small wonder, then, that organizations have developed an additional financial service: to help you through the maze of personal money management. The following will discuss what we feel is important to look for in a professional personal money manager.

I. WHAT IS PROFESSIONAL MONEY MANAGEMENT?

Basically, this is a rather broad term that covers two types of activity: financial advice and investment management. The former usually involves any or all of the following areas: all lines of personal insurance; debt management; bill paying; income tax planning and possibly preparation; estate tax planning; investment portfolio reviews; and financial goals analysis.

Investment management involves either offering advice (nondiscretionary relationships) or making investment decisions for clients (discretionary relationships) in one or more investment areas. These can range from such low risk investments as cash equivalents (e.g., CD's, T-Bills, etc.) through moderate risk investments such as stocks and bonds to high risk investments such as real estate, oil and gas ventures, commodities, gold, and the like.

II. SHOULD YOU CONSIDER PROFESSIONAL MONEY MANAGEMENT?

If you are too busy with other affairs, as is a business executive, or have not had the opportunity to develop this expertise, as may be a widow or a young inheritor, or simply are not inclined to do it yourself, then engaging a professional money manager may be for you.

If you feel one or more of the above conditions applies to you, there are several more things you should resolve before venturing forth to find a professional money manager.

1. Make sure you can take advice from someone else. If you are used to making your own decisions free of outside input, you may find the addition of an outside advisor unsettling. Therefore, you should assure yourself that you will maintain an open mind toward your advisor's recommendations. Otherwise, why pay for such services?
2. Make sure you can develop a relationship of trust with your advisor. Admittedly, this is something that he or she must earn, and it takes time; but if you are not prepared to give trust under any circumstances, you probably won't have as healthy a relationship with your advisor as you should.
3. You may be emotionally "married" to some of your financial resources. Apart from the wisdom or lack thereof of such a position, it may be unwise to ask your advisor for advice in these areas. For example, if you own stock in a company founded by your father, and you couldn't bear parting with it, it would not be productive to ask your advisor whether you should hold or sell this stock if there is only one "right" answer in your mind.
4. You should understand the difference between "making" and "managing" money. The former involves concentrating your energies, abilities, and financial resources in an enterprise over which you exert some control. If you are successful and lucky, you might be able to realize a considerable return on your financial investment after a period of time.

Managing money involves investing in opportunities over which exerting some direct control is impossible (e.g., buying shares in IBM). One of the principal concerns here is to try to anticipate changes in the market value of investments before they occur. Because no one can be consistently prescient in these matters, it is often advisable to reduce your risk exposure by diversifying among investment opportunities. This means accepting a lower potential return on investment, and this is the crucial difference between "making" and "managing" money.

5. Finally, you should do some real soul-searching about two very important considerations. First, what are your financial goals? To the best of your ability, you should be able to express what these goals are, when you want them to occur, and how much they would cost. Second, you should also attempt to "intuit" what level of investment risk you are willing to accept. (We say "intuit" because no one has yet devised a scientific method of measuring this emotional consideration.) If you are not able to express these feelings and expectations to your advisor, he or she will have difficulty serving your needs.

III. WHO ARE PROFESSIONAL MONEY MANAGERS?

In the financial advisory area, your options are numerous. CPA's, bankers, brokers (both securities and insurance), and independent individuals and organizations all offer advice in some or all of the areas discussed earlier.

In the investment management area, the great majority of counselors manage cash equivalents, bonds, and stocks. A few have expanded to cover real estate or one other investment area. Then there are numerous individuals or organizations who counsel primarily on one investment vehicle such as gold, precious stones, commodities, option writing, oil and gas ventures, etc.

IV. WHAT DOES IT COST?

There are two basic costs associated with personal money management: brokerage commissions and advisory or management fees. The first occurs when a financial product is sold and is some small percent of the value of that product (1-8%). Advisory fees are most commonly charged on an hourly basis. Occasionally a broker will give you financial advice for free or at a below market rate, hoping to make up the difference in brokerage commissions from selling you products he recommends that you buy.

Investment management services may be offered by a broker under the circumstances just discussed. Alternatively, you can pay an investment counselor a small annual fee (0.5%-2% of assets managed) for these services.

V. HOW DO YOU EVALUATE A PERSONAL MONEY MANAGER?

When looking for a financial advisor there are at least five things you should investigate.

1. What are the prospective advisor's qualifications? Here, information on educational background and actual experience is essential.
2. Is the advisor's self-interest aligned with yours? Admittedly, someone trying to sell you their service will not always be the most objective person as to whether you really need this service (financial advice). This is a decision you must make. Once made, however, it is best if your advisor can have your interest exclusively in mind when advising you on other financial products and services. If he or she receives his or her remuneration solely from fees charged to you, the chances of this occurring are greater than if he or she also stands to gain from fees or commissions generated by selling services and products. Under the latter circumstances, your advisor could have substantial potential conflicts of interest.
3. What services is the advisor prepared to provide, and how will they be delivered? You shouldn't go to a debt counselor for tax planning or to a tax preparer for an analysis of your investment portfolio. Also, find out how frequently you will interact with your advisor and whether this will be in person, by phone, and/or by letter.
4. How does the advisor balance his or her time between business development and delivering client service? This is often a very difficult thing to determine, but nevertheless important for you to know. The advisor who overemphasizes his business development activities often develops too many clients too quickly to effectively serve each one's needs. Alternatively, an advisor at the other extreme will probably have trouble remaining profitable and might go out of business. It is important that your advisor have the capability of pursuing the tasks of business development, client service (including good reporting and record keeping), and research with equal dedication.
5. Do you feel comfortable on a personal level with your prospective advisor? It has been this writer's experience that emotional considerations are very important in the relationship between client and professional money manager. Therefore, you should make sure that you like your advisor as well as admire his or her professional abilities.

6. What perspective can the advisor bring to your situation? An advisor who concentrates in a narrow area of investments might not have an appreciation for other alternatives and possibly be biased toward recommending only his area of expertise to you, regardless of how "right" it is for you. On the other hand, you might at least be able to get quality service in that area because of the specialized knowledge the advisor possesses.
7. How will you be charged for this service? If the fee is on an hourly basis, get the advisor to give a "hard" quote as to the maximum to be charged that he or she can live with once you have given him or her the opportunity to assess how much work is actually involved. If you are quoted a fixed fee for a "packaged" analysis, make sure the areas to be covered in this report really apply to your circumstances. Finally, it is this writer's bias that you get what you pay for, so beware of advisors offering "free" advice.

When looking for an asset manager, the discussions under 1, 3, 4, 5, and 6 apply here as well. The consideration of fees is slightly different, however. With the exception of certain privately circulated investments, some brokerage commission must be paid when buying or selling publicly offered investments. The question then arises: What is the justification for paying an asset management fee on top of brokerage commissions? Generally, people who are willing to incur this additional cost do so to have the peace of mind knowing that their investment manager does not have any potential conflicts of interest.

Finally, an asset manager should have investment expertise to be able to effectively diversify your portfolio. In this writer's opinion, that means spreading your assets across enough investment areas and issues to offer some hedge against five types of risk.

1. Inflation/deflation: real estate, gold, and precious stones deal with the former; bonds and cash equivalents, the latter.
2. Interest rate changes: bonds and stocks are good when rates are falling; bonds are extremely poor when rates are rising; cash equivalents are probably good here.
3. Business risk: diversification among a group of unrelated investment vehicles avoids the problem of having all your eggs in one fragile basket.
4. Market risk: diversification among several unrelated investment areas means, for example, having a percentage of your assets in real estate when the stock market turns.
5. Illiquidity risk: cash equivalents, bonds, and stocks are good here as opposed to real estate, oil and gas ventures, and farming ventures.

CONCLUSION

All of us are aware of how complex and constantly changing is the area of personal finance. We trust this article has shown you the real opportunity that exists to obtain professional assistance through this maze. If you have expended considerable energies and talents to accumulate financial resources, or are the recipient of a valued inheritance, you deserve to have these resources handled in a prudent and professional manner.

20 · Real Estate

OBJECTIVES After studying this chapter, the students should be able to:

- Explain when and how to invest in first and second mortgages (or deeds of trust).
- Explain when a real estate investment trust (REIT) would be a wise investment.
- Explain when a real estate limited partnership would be an appropriate investment.
- Explain how to discriminate between potentially successful and potentially poor real estate limited partnerships.

SUGGESTED APPROACH This is one chapter of the text you may wish to omit parts of if you feel that other topics are of greater immediate importance to your students. For adult students, however, this chapter presents some important topics that they should understand.

1. *Second mortgages and deeds of trust.* Many people find the practices of second lenders objectionable because of the high interest costs. Indeed, while the laws in some states make it illegal to charge over 10 percent on a real property loan, the front-end points added on by lenders often raise the effective annual rate of such loans to 16 or 18 percent. We would advise students to ask themselves whether they really need the loan or to try borrowing from their bank, savings and loan, or credit union before going to second mortgage or deed of trust brokers.

For investors, however, mortgages and deeds of trust can be excellent, high-yield investments as long as they select them according to the guidelines in the text and do not risk a major drop in real estate prices due to a currently speculative market. Since such a technical investment is often difficult for a layperson to evaluate, we suggest you stress in class that a prospective investor seek out the mortgage broker with the most experience and the best loss record in the community, rather than merely finding one through the yellow pages of the phone directory.

2. *Houses, duplexes, and triplexes.* In 1979, the time of this writing, house prices were soaring. We see this phenomenon as the speculative "blow-off" phase of the price momentum begun by the inflationary experience of this decade. Unless incomes begin to rise rapidly, house prices must at least level off for a while, if not actually decline. Thus, the point of this section is that

there is no profit in holding such investment properties *unless* one gets price appreciation, and this is not guaranteed, no matter what real estate sales-people say!

The following discussion may be a useful springboard for class discussion. It is reprinted with permission from Bailard, Biehl & Kaiser, Inc.'s "Economic Analysis and Investment Outlook" letter of May 1979.

Since journalists usually find economic issues to be newsworthy only when things are at extremes, we have found the press to be an unusually reliable indicator of major stock market tops and bottoms. Cover stories in the weekly magazines on bull markets or bear markets usually appear less than a month prior to the turning point.

In this light, we view as potentially significant the April 17 special 20-page tabloid section of the Peninsula Times Tribune on single-family homes on the San Francisco peninsula entitled "Land." We quote from, and comment on, some of the typical thinking that occurs at market tops, as taken from that publication.

"Between 1971 and 1977, median household incomes rose 42.5% and housing prices rose 151.4%. That disparity is expected to continue." How? Will lenders eventually offer 95% loans with a 60-year amortization schedule? Or, will homeowners find a way to spend more for their house payments than the 40% of income they're already squeezed at today?

"In Palo Alto less than 10% of the city's residents already owning homes could buy a median priced Palo Alto home if they were forced to make their first purchase today. In Sunnyvale, in 1971, 64% of the residents could have bought the median priced home. Today, less than 20% could make such a claim!" The obvious conclusion, not made in the article, is that the pool of new buyers able to push the market to new highs will eventually shrink to a size too small even to provide the demand to maintain present prices.

"We hardly ever see anyone under 30 applying for a loan here anymore." How will the local economy be maintained in the long run without a continual supply of "new blood"?

Finally, here are some quotes that need no comment, except that they sound remarkably like the stock market literature of the late 1960s.

"Typical economics just don't apply here."

"Buy before it gets worse."

"Beg, borrow, or steal to get your first home."

"A Tudor home in Los Altos cost \$150,000 in 1976. Its asking price today is a stunning \$325,000. In just five years it will market for \$600,000."

"How high can real estate prices go? Very high."

"I just can't conceive of its going down in any way."

Although we do not advocate disrupting your lifestyle and taking the risk of selling your personal residence, we do strongly recommend the sale of any rental homes you may be holding for speculative reasons.

3. *Real estate investment trusts (REITs)*. Point out that these are often appropriate investments. The following are some additional guidelines instructors may introduce in class to help their students make such investments wisely.

- Stick to REITs with good, long-standing reputations and good records. This is a new and highly competitive industry. The ones with poorer management or weaker financial backing have not survived.

- For the investor seeking long-term appreciation prospects, the REIT with a higher proportion of equity investments rather than mortgage investments would be appropriate.
- One of the keys to buying good value is to compare the market price to book value—the greater the book value coverage, the greater the probable security of the market price.

4. *Real estate limited partnerships (syndicates).* The instructor should prepare the student to deal with this now somewhat commonplace investment medium. These investments have become more popular for the following reasons.

- Many investors are seeking diversification outside the stock market.
- As earned income rises among American families, they find themselves in 30, 40, or 50 percent combined state and federal tax brackets and begin to seek tax shelters or, at least, tax-sheltered income.
- Many investors who want the tax shelter of real estate investments are too busy to manage such investments on their own.

From our experience, large-scale income properties, which are the typical investment of real estate syndicates, are no longer the secure, high-return investments they once may have appeared to be. The reasons are several:

- The waves of limited partnership offerings and foreign investment money have resulted in high inflows of investor dollars, periodically driving up the price of such real estate and thereby reducing potential total return and cash flow rates and raising the break-even occupancy levels.
- Property taxes have risen faster than rent levels, putting a further squeeze on net cash flow to the investor and also raising the occupancy level needed to break even.
- Local communities have become concerned with congestion, shoddy construction, and the like; as a result they have begun to reduce the rate of new construction, thereby putting further upward price pressure on existing properties in certain areas.

Further compounding the risk problems for the investor, the new demand for such limited partnerships has brought a number of inexperienced syndicators into the business. Some syndicators, experienced or inexperienced, may take various management fees that are unjustifiably high and thereby reduce the return to the investor. As a consequence, the SEC, the NASD, and many state regulatory bodies are promoting strict regulation of real estate syndicators, particularly with regard to complete disclosure to prospective investors and a limitation on chargeable fees. In any case, the investor must be aware of these problems and attempt to minimize their effect through discriminating investment selection.

In our opinion, the following are important factors for the investor to consider when deciding whether to invest in a real estate syndicate:

- Syndicator experience, expertise, and financial strength to stand behind the partnership (The general partner should be a substantial firm with at least three to five years of experience in acquiring, financing, and managing real estate income property.)

- Amount of leverage used (The smaller the cash down payment as a percentage of total cost, the higher the break-even occupancy level and the greater the risk; 20 to 40 percent is an appropriate range for the down payment as a percentage of the total cost, depending on investor conservatism.)
- Prices paid for the properties in terms of gross multipliers and capitalization rates

Nobody can consistently pick winners. Thus, for diversification reasons, we are inclined to favor the diversified property portfolios (even blind pools) over the specific property syndications. However, specific single property syndicates that are privately placed may have a lower front-end cost and therefore be attractive to the wealthy investor. Even with specified properties, one must realize that syndicators often try to make the price look better than it really is by doing three things:

- Overstating rent levels in order to reduce the apparent gross multiplier (The investor should check on competing rents in the immediate vicinity of the property.)
- Understating expenses (especially property taxes) in order to boost the capitalization rate (Expenses should be at least 35 to 40 percent of gross rents, not including the 5 percent vacancy allowance.)
- Underestimating start-up maintenance costs for an old building or occupancy fill-up rates for a new building and failing to provide sufficient working capital to the partnership (The syndicator is tempted to do this in order to reduce the investment capital that must be raised and thereby boost the projected return on investment.)

The rest of the considerations relevant to this somewhat complex topic are discussed in the text. For potential investors who, after completing this portion of the text, are still unwilling to trust their own judgment, we strongly recommend that they invest only with highly reputable firms and/or seek professional assistance from financial advisors, attorneys, or CPAs who can demonstrate both that they have no conflicts of interest and that they have experience qualifying them to offer such advice. Such assistance may well be worth its cost if it enables the investor to avoid the many syndicates that we have seen become a total loss.

The following story is reprinted with permission from the June 1978 issue of the "Economic Analysis and Investment Outlook" of Bailard, Biehl & Kaiser, Inc.

SAMPLE CASE

We have had difficulty locating factual information on real estate prices prior to World War II, except for some studies on Midwest farmland prices, New York City flats, and Los Angeles County deed recordings. Thus, we were pleased recently to meet a man who was in the real estate lending business in California from the time he graduated from college in 1923 until his retirement in 1964. It is unusual to find a well-placed eyewitness whose career stretches so far back and whose recollection of those early years still seems quite good.

His story of the twenties and thirties in Southern California was so interesting, one that perhaps offers insight into today's market conditions, that we thought we should devote this newsletter to it. First, two caveats: (1) *We are unable to verify the accuracy of his story; and (2) even if the cycle repeats itself, which it might, important details are likely to be quite different.*

Our gentleman, Mr. "G" we shall call him, was promoted in 1926 out of a San Francisco building and loan home office job to the managership of a branch office in a small coastal town in Southern California. (Building and loan companies were the forerunners of today's savings and loan institutions.) Back then, lenders made loans only to very qualified buyers, as evidenced by the following loan terms and underwriting standards.

1. The maximum loan was 75 percent of appraisal. (Insurance companies lent only 60 percent on a first loan.)
2. Loans were fully amortized over either 10 or 15 years.
3. A wife's job income was not included because it was assumed in those days that she would not continue to work after she became a mother.

The balance of a new home purchase was made up of, typically, some down payment, street bonds, and a second mortgage from the builder. By the late twenties, in order to make loans, the lenders would offer up to three years' interest-only loans before the 10-15 year amortization period would begin.

In 1929, the real estate market collapsed along with the stock market and caught everyone by complete surprise. Mr. G spent the next couple of years trying to salvage loans by foreclosure. On reselling a foreclosed home, it was not uncommon to get only 50 percent of the value of the loan. This would indicate a market price decline of about 63 percent from the appraisal.

Savings account holders submitted written withdrawal requests, and were placed on a waiting list. Most were happy to cash out for 50¢ on the \$1. (Neither savings and loan nor bank accounts bore federal deposit insurance in those days.) By the late thirties, those savers who waited to cash out eventually did receive 100 percent from this particular firm.

In 1931, in an effort to obtain more job security, Mr. G left the building and loan and went to work in Los Angeles for a major New York-based life insurance company, which was actively hiring people who could help salvage their rapidly deteriorating portfolio of single-family home loans. Homeowners were so afraid the world was coming to an end that many stopped paying on their loans. After all, the market value of the home was less than the total indebtedness against it. Of course, many other people were unable to keep up the payments even if they wanted to.

Mr. G's job was to try to persuade people that the shelter they had purchased was still as desirable to them as it was at the time of purchase and that they should get their loans current again. As an incentive to do so, the insurance company was prepared to: (1) charge interest-only for the time being; (2) forgive all back interest except for one-month's worth; and (3) loan the homeowner the money needed to bring the property tax payments current again.

Mr. G said that they were beginning to make some progress when President Franklin Roosevelt announced the formation of the Homeowners Loan Corporation (forerunner of the FHA) to insure and protect home loans. Immediately, homeowners believed that Uncle Sam would take care of everything, and they let their loans lapse again. Now, in order to save their assets, the lenders had to get the borrowers to apply for the government program.

In 1938, Mr. G grew tired of the "bring the loan current or we will foreclose" business and became the chief mortgage officer for Northern California for a smaller San Francisco-based insurance company, where he stayed until he retired in 1964.

Mr. G's experiences in those early years obviously left a strong impression, and he passed up the chance to make substantial profits in real estate investments since the war, except that he bought a home in San Francisco for \$26,000. A couple of years ago, he sold that home for \$145,000 and became a renter. He put all of his assets in

insured savings and in utility company bonds. Some of the signs warning him of a repeat of 1929 are:

1. Lenders are forgetting about appraisals and simply loaning 80 percent of the purchase price in order to make the loans. (Note: This is not so true recently, as available mortgage funds to lend have diminished.)
2. Builders are selling homes by making second mortgage loans to the buyers.
3. The second loan market is actively booming again.

It is our opinion that various government safeguards in the economy will probably prevent a violent crash such as occurred in 1929. However, as you are aware from our letters dating back to January 1977, we are very concerned about the inflated state of the housing market in California, and we would not be surprised to see a period of stagnation and significant price decline begin within the next one to three years.

See the appendix on "Investing in Real Estate Limited Partnerships" for additional background material.

ADDITIONAL TOPICS FOR DISCUSSION

For adult courses, the instructor may want to have a representative of a real estate syndication firm use the following outline, which the authors have used often in educational half-hour sessions with only a modestly experienced audience.

GUEST LECTURE IDEAS

Real Estate Syndications: Solid Investments or Tax Shelter "Rat Holes"?

- I. Introduction
 - A. Good investment packages for \$3,000 and up
 - B. BB&K's investment counseling viewpoint on the industry
 - C. What is a "syndication"?
- II. How real estate investments should work (an apartment building example)
 - A. An apartment building purchased for \$2,600,000 with a \$1,900,000 mortgage
 - B. Cash flow to the investors

Scheduled rents	\$400,000	
Less: vacancy allowance	(20,000)	
Collected rents		\$380,000
Less: property taxes	(65,000)	
property management	(25,000)	
utilities, insurance, repairs, etc.	(50,000)	
replacement reserve	(15,000)	
Total expenses		155,000
Net Operating Income		225,000
Less: mortgage payments		(190,000)
Property cash flow		35,000
Less: partnership management		(5,000)
Partnership's Cash Flow		\$ 30,000

C. Taxable income to be reported (an early year)

Net operating income	\$225,000
Less: partnership management	(5,000)
interest on mortgage	(177,000)
depreciation (straight line)	(75,000)
Plus: replacement reserve	15,000
Taxable Income	(\$ 17,000)

D. Details can vary greatly depending on geographic area, management's ability, structure of the deal, and so on.

III. Why many syndications didn't work that way

A. Too much leverage (too little cash invested by partnership)

1. Too difficult to break even
2. Purchase price too high

B. No reserves

1. Initial
2. Operating

C. Leaseback management

1. Bankrupt lessee
2. "Run down" the property

D. Raw land deals: too difficult to hold partners together.

E. General partner was a "tax shelter" expert only.

F. General partner failed to survive.

G. Poor property selection or bad luck

IV. 1976 Tax Reform Act

A. No prepaid interest

B. Accelerated depreciation undesirable for high-salary investor

C. Construction period write-offs to be taken over longer period

V. Key ingredients for success

A. Sound general partner

B. Reasonable leverage and reasonable price

C. Reserves

D. "In-house" property management

E. Stick with conventional, general purpose, income real estate.

VI. Some thoughts for the investor

A. Retain personal liquidity

B. Diversify by property and general partner

C. Do a little research before investing

D. Industry trends

1. Government regulation and prospectus legalese
2. Private placements and "no-load" blind pools

**ADDITIONAL
MATERIALS AND
ACTIVITIES**

1. Have one or more local second mortgage brokers speak to your class and explain how to evaluate a second loan from the prospective investor's point of view.
2. Have your students ask a stockbroker to show them, or else help them construct, a list of leading REITs, including their market price, book value, dividend yield, and ratio of mortgage loans to equity investments.

3. Have your students gather several prospectuses of real estate limited partnership offerings and compare them. The basis for comparison should be the points listed in the text plus any you mention in class.

1. Risks that must be assumed are the possibility of default by the borrower and the possibility that, in the event of foreclosure, there might be insufficient cash proceeds on the foreclosure sale to cover the second loan balance.
2. All interest received is taxed at ordinary income tax rates.
3. An acceleration clause prevents the borrower from assigning his or her debts to any other person without permission from the lender. This prevents the owner of the property from selling it to someone the investor/lender considers a poor risk without paying off the loan balance. (If the owner does sell to a bad risk, the lender can foreclose.)
4. The short-term mortgage REIT emphasizes investments in first and second mortgages (primarily in construction and development loans). The long-term equity REIT concentrates on long-term first mortgage loans against completed, operating properties. The equity REIT emphasizes equity investments (ownership positions) in income-producing real estate properties.
5. The equity REIT would be preferred by the investor who has only a small amount to invest, wants to avoid the illiquidity of the limited partnership type of investment required for a real estate syndicate, and/or does not need the extra tax shelter provided by a real estate syndicate investment.
6. Blind pools do not specify in advance the properties to be acquired; single property syndicates do. Blind pools offer diversification for the investor with limited investment capital; single property syndicates do not. Specified or single property investments allow for closer investor scrutiny prior to investing, but provide diversification only if several properties are offered in the same partnership.
7. The three types of financial items are tax savings, annual cash flow, and after-tax cash received on resale of the property.
8. Three potential risks are:
 - Too high a purchase price may result in price depreciation.
 - The building may not remain occupied above its break-even levels.
 - The IRS may disallow some or all of the tax deductions.
9. Price appreciation, primarily as a result of inflation.

ANSWERS TO CHAPTER QUESTIONS

Student-Oriented Case Problem

1. The answer to this question requires more background than the student may have. Our recommendation would be that the Winkelmanns consider the equity REIT because of its diversified real estate portfolio, growth potential, and partial tax advantages.

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEMS

The blind pool syndicate might also be appropriate except for two possible drawbacks. First, the \$5,000 minimum investment would tie up more than half of their investment liquidity—a position we do not often recommend. Second, the 30 percent tax bracket is a bit low to really justify the risks. We generally advise investors to pay their taxes if their combined federal and state brackets are less than 40 percent. (They might be well advised to build up their liquidity in order to be able to make such investments later when they are in higher tax brackets.)

The single property syndicate is less appropriate than the blind pool because it offers no diversification.

The mortgage REIT and second deeds of trust are high income items with little or no growth potential. As such, they are not appropriate for investors in 30 percent and rising tax brackets who are seeking a hedge against inflation.

2. The first-year tax deductible loss is \$2,000 ($40\% \times \$5,000$). Therefore, the first-year tax savings (cash return due to the tax loss) amount to \$600 ($30\% \times \$2,000$).
3. For the equity REIT, they should invest at least \$2,000 to keep brokerage commissions reasonable, but no more than that in one REIT because they should diversify.

For the blind pool (if they are willing to live with illiquidity and higher risks), they should invest no more than the \$5,000 minimum.

Although we do not recommend these selections, other acceptable answers would be as follows.

- They should invest no more than \$5,000 in the single property syndicate.
- If they selected the second deeds of trust, they should invest no more than \$5,000 in them (for reasons of portfolio diversification).
- No more than \$5,000 should be invested in mortgage REITs.

Liquidity is one issue. If they were to invest all of the \$8,000 in one of the syndicates, they would have no liquidity and no investment flexibility.

4. To allow for emergencies, liquidity, and diversification into other areas of economic activity, we would suggest they put their first-year investment into a common stock mutual fund.

Chuck and Nancy Anderson Their Real Estate Investment Program

1. Equity REITs and syndicates are probably the most appropriate for the Andersons because they offer ownership positions that allow them to achieve their long-term growth objectives. Also, a hedge against inflation is certainly warranted when one is looking at a 30-year investment program. In addition, the tax advantages are appropriate in view of the Andersons' tax bracket.

The other alternatives seem inappropriate. Second deeds of trust and mortgage REITs would not have the after-tax return, long-term growth, and inflation hedge the Andersons are looking for (according to the diversified investment strategy outlined in Chapter 15 of the text).

2. This is an open-ended research question to be assigned and qualified by the instructor.
3. One \$5,000 commitment to a diversified syndicate would not be inappropriate, although it reduces the Andersons' liquid assets to a level we would not generally recommend. In this sense an equity REIT would be better. Offsetting this is the consideration that the market value of the REIT shares might not reflect any appreciation in the market value of the real estate held by the REIT. Given the Andersons' long-term horizon and apparently sound job income, we would be inclined to recommend taking the illiquidity risk of the syndicate.

**SAMPLE TEST
QUESTIONS**

Objective Questions

Circle the letter of the correct answer to each question.

1. Which of the following is the safest income investment?
 - a. First deeds of trust
 - b. Second deeds of trust
 - c. 6 percent FSLIC insured savings
 - d. Mortgage REIT
2. Which of the following offers the highest probable current income yield?
 - a. First deeds of trust
 - b. Second deeds of trust
 - c. 6 percent FSLIC insured savings
 - d. Equity REIT
3. Which of the following is the greatest possible risk in a second deed of trust investment?
 - a. Four to six months' waiting period in case of foreclosure
 - b. Lack of an acceleration clause
 - c. Too small a penalty for late payments
 - d. Insufficient proceeds to cover the loan in a foreclosure sale
4. What is the most important item for an investor to look for in selecting a second mortgage broker?
 - a. A very low foreclosure and loss record
 - b. High prepayment penalties
 - c. His or her investment objectives
 - d. Location in a big city
5. Which of the following does NOT offer a way to participate directly in all the advantages of real estate investing?
 - a. Blind pool syndicate
 - b. Real estate investment company common stock
 - c. Equity REIT
 - d. Single property syndicate
6. Which of the following makes a REIT like other common stocks?
 - a. Market price is determined by supply and demand forces in the securities markets.
 - b. Ninety percent of the income must be distributed to the shareholders.
 - c. It must have at least 100 shareholders.
 - d. It invests at least three-fourths of its money in real estate investments.
7. The total potential yield on a real estate syndicate investment is comprised of
 - a. cash flow, equity buildup, and tax shelter
 - b. interest, equity buildup, tax shelter, and price appreciation
 - c. cash flow and tax shelter
 - d. cash flow, tax shelter, equity buildup, and price appreciation

8. Which of the following is NOT a risk of investing in a real estate syndicate?
- a. The property may be bought for too high a price.
 - b. The building may not stay rented above its break-even level.
 - c. The first mortgage may not be insured by the FHA or VA.
 - d. The general partner may go out of business.
9. As an investment, a single property syndicate is best suited for
- a. a person in a high tax bracket who already has both sufficient liquid investments and other real estate investments
 - b. A retired couple who have only a few other investments and Social Security and are seeking additional living expense income
 - c. a young couple in a high tax bracket who are seeking an outlet for the first \$5,000 they have managed to save
 - d. (All of the above)
10. Which of the following should the investor examine before investing in a blind pool syndicate?
- a. The syndicator's experience, expertise, and past record
 - b. The use of realistic vacancy allowances
 - c. Appropriate market prices as measured by the gross income multiplier
 - d. (All of the above)
11. One can usually count on getting more than enough rent from a single-family home investment to cover the taxes, insurance, mortgage, repairs, and other expenses plus a reasonable return on your cash investment.

True

False

Essay Questions

1. What are the differences in management, control, and potential return between a limited partnership investment and a fourplex?
2. Suppose an equity REIT is set up to have a limited life of 10 years, beyond which the trustees are obliged to sell the real estate and liquidate the REIT by distributing the proceeds to the shareholders. What would be the two major differences between this and a partnership?

**ANSWERS TO
SAMPLE TEST
QUESTIONS**

Objective Answers

1. c The others are not insured.
2. b Seconds usually offer 10 percent or more—a higher current yield than the other choices.
3. d The others are also potential risks, but can be insignificant if the second lender is careful not to lend too much against the property or if property values decline from overinflated levels.
4. a This is your best indication of quality
5. b The corporation cannot pass the tax advantages on to the investor.
6. a The other features generally apply only to REITs.
7. d See text discussion for further explanation if necessary.
8. c This is a risk on the part of the lender, not the equity investor.
9. a “b” is inappropriate since equity real estate investments are not a reliable source of income; “c” is inappropriate because of the lack of both liquidity and diversification.
10. a “b” and “c” can be examined in a syndicate only when the properties are specified in the offering.
11. F In recent years, rental income on single family homes is barely sufficient to cover property taxes and normal mortgage payments. Funds for repairs, vacancies, and so on, usually come out of the landlord’s pocket.

Essay Answers

1. A fourplex requires more management involvement by the investor while a partnership is a passive investment, managed by the general partner. The fourplex offers more control because the investor can determine when to sell, refinance, and so on. Potential cash income is higher in a partnership due to the economies of scale in a large investment although the total return may be lower than in a fourplex because of the management fees and profit sharing to the general partner.
2. One, the REIT shares would be freely transferable whereas there would be restrictions on the transfer of partnership shares. Two, there would be no excess tax shelter provided by the REIT (although the depreciation deductions could shelter the dividends of the REIT).

**APPENDIX
MATERIAL**

“Investing in Real Estate Limited Partnerships” (a discussion distributed to clients of Bailard, Biehl & Kaiser, Inc.)

INVESTING IN REAL ESTATE LIMITED PARTNERSHIPS

Real estate - including limited partnerships, personal residence, and other personally owned real property - is an integral part of every client portfolio under BB&K management. The amount devoted to real estate in your portfolio will depend on our economic outlook, your risk level, your objectives and your liquidity needs.

A. COMMON ELEMENTS OF RECOMMENDATIONS

Certain generalities can be made about BB&K-recommended real estate investments.

- 1) The investor is principally in an equity ownership position, rather than a lending position.
- 2) The properties are almost exclusively improved, income-producing properties, rather than raw land, which is a speculative investment whose success depends on localized expertise. The actual property type involved (e.g., apartments, shopping centers, mobile home parks, industrial or office buildings) depends largely on the current availability of good opportunities.
- 3) The investor typically has limited liability and little or no management responsibility. This is achieved principally via the limited partnership structure, where the responsibility rests with the general partner, or via a real estate investment trust (REIT), where the responsibility lies with the trustees and advisers. In no case are the general partners, trustees, or advisers affiliated with BB&K.

B. SECURING GOOD REAL ESTATE MANAGEMENT

There is much more involved in successful real estate investing than just buying a good property at the right price. It must also be managed effectively to increase the net operating income and thereby improve the potential market value of the property. Finally, it must be sold or refinanced to net the greatest potential return of capital to the investor.

Thus, BB&K emphasizes the selection of able and honest management. The review of actual properties is only a part of the process of selecting and monitoring the management itself. In fact, because one of the ways to obtain low purchase prices for real estate is in the promise of a quick escrow, BB&K often recommends an investment in which few, if any, of the properties are selected prior to the investor's commitment. Such programs which raise investor capital prior to property acquisition are called "blind pools".

What are the circumstances under which some or all of the properties (and their purchase terms) will be known by the investor prior to his commitment? One or more of the following may apply.

- 1) The investor buys into an on-going entity:
 - a) by buying shares on the open market from other investors subsequent to the original funding period; or

- b) by buying into a program with a long fund raising period, where prior investors' capital has been invested in real estate before the closing date for new investors.
- 2) The management is able to commit to property prior to investor funding by either:
- a) utilizing its own bank line of credit to close escrow early (and then resell at cost to the investor); or
 - b) finding those circumstances in which the seller is willing to accept a long escrow period (over 60-90 days), without asking for a higher purchase price to compensate for the delayed close of the deal.

C. COMPONENTS OF INVESTMENT RETURN

The investment returns from real estate are in three categories: annual cash income, tax benefits, and return of capital on resale or refinancing.

1) Annual cash income. Depending on the objectives of the particular investment program, one can typically expect annual cash income ranging from 3-8% per year on the original investment. In the case of properties bought during or shortly after construction, the annual cash flow may not begin until up to 18 to 30 months following the investment. The actual cash received by the investor may be less (or even zero) if either:

- a) the property is undergoing operating problems (discussed under "business risks" later in this memo); and/or
- b) the management has temporarily elected to retain operating cash flow in the program in order to build cash reserves against possible future emergencies. In such cases, if the cash reserves are not needed, the money will eventually be paid out to the investors. Such cash reserves are never the legal property of the general partner or the trustee, but belong to the investors.

2) Income tax benefits. Real estate investing offers a complex variety of tax benefits. The net effect of these benefits is generally to offer tax losses in excess of the rental income in the early years, thereby providing tax losses to offset other earned or investment income. In later years, the shelter is usually only sufficient to make part of the annual cash flow free of current income taxes. Eventually (after, say, ten years) the taxable income may exceed the cash flow, as the deductions for mortgage interest and for depreciation decline.

Real estate tax benefits can be classified into three general categories, some or all of which may be present in any one investment.

- a) Permanent tax forgiveness occurs when there is property or equipment subject to an investment tax credit. This may be used as a direct credit against your current year's tax bill. This is usually a very small item, however.
- b) Conversion of ordinary income to capital gains income is the principal tax benefit. First year bonus depreciation and ongoing straight line depreciation of the permanent improvements to the property are deductions against current income and reduce the cost basis of the property for calculating the eventual capital gains on resale. In short, depreciation offers deductions against ordinary income which are generally later "recaptured" at more favorable capital gains tax rates.

- c) Deferral of tax liability to future years is a benefit in possibly two ways: i) transferring taxable income from a high tax bracket year to a lower tax bracket year, thereby effecting permanent tax savings; and ii) obtaining, in effect, an interest-free loan from the IRS by deferring your taxable income. Deferral of income is typically achieved via the use of one of several methods of depreciation accounting which provides for deductions in excess of straight line depreciation in the early years, but less in the later years. In the event of a sale, depreciation in excess of straight line will be recaptured as ordinary income.

3) Return of capital on resale or refinancing is a function of the current market, or appraised, value vs. the original purchase cost. Generally, in order for the value of an income property to rise above its purchase cost, the net operating income must rise. Sophisticated investors nearly always relate the price to the property's income producing potential, as measured via the capitalization rate, gross multiplier, and other yardsticks.

As an example of what might reasonably occur over five to ten years, consider the following property.

	<u>PURCHASED WITH MORTGAGE</u>	<u>PURCHASED WITHOUT MORTGAGE</u>
MORTGAGE	\$750,000	0
INVESTOR EQUITY	250,000	\$1,000,000
<u>PURCHASE COST</u>	<u>\$1,000,000</u>	<u>\$1,000,000</u>
RESALE PRICE	\$1,130,000	\$1,130,000
MORTGAGE BALANCE	(680,000)	(0)
<u>RETURN OF CAPITAL</u>	<u>\$450,000</u>	<u>\$1,130,000</u>
AS PERCENT OF EQUITY INVESTMENT	180%	113%

By buying real estate subject to a mortgage, one utilizes financial "leverage" and thereby enhances the potential return (and also increases the risk, as discussed in the next section).

Two additional items should be noted on such a sale. One, there will be considerable capital gains taxes, and possible recapture taxes, due on sale since depreciation deductions taken during the holding period will have reduced the tax cost basis well below the original purchase cost. Two, part of the sale proceeds may be received in the form of a second deed of trust, with payments due over several years with interest, in order to obtain the best possible sale price. (Many buyers are willing to pay a higher price to obtain extra leverage, which can be created by using a large second mortgage.

What about refinancing? This is often an excellent way to recover capital out of a property without triggering the taxes that are due on a sale. For example, the \$1,130,000 property illustrated above might qualify for a 75% bank mortgage, or \$847,000. After these proceeds have paid off the old loan (\$680,000 balance), there remains \$167,000 to distribute tax deferred to the investors, who would still own the property.

D. COMPONENTS OF INVESTMENT RISK

The most complete discussion of risks in a real estate investment program is normally contained within the prospectus for that offering. However, we believe it is useful to restate those risks in terms of the five categories of risk we normally consider: 1) inflation/deflation; 2) business; 3) interest rate; 4) market volatility; and 5) liquidity.

1) Inflation/deflation risk. The market value of real estate normally responds positively to inflation, provided the higher cost of living is translated into higher rental income. In the short run (2-5 years), this might not be the case because of temporary overbuilding, rent controls, fixed leases, or other problems. In the long run, real estate values tend to increase at about 75% of the rate of general consumer prices. Conversely, in times of deflation (such as we had in 1926-33), real estate prices declined along with consumer prices.

This inflation benefit, or deflation risk, is amplified by the use of leverage. If the investor puts 25% down on a property, a 25% rise in market value will double the equity, and a 25% decline will eliminate the equity.

2) Business risks. Certain risks are a potential threat to an entire real estate portfolio, regardless of the diversification within the portfolio. These include:

- a) rent controls or price controls;
- b) Congressional tax law changes;
- c) IRS challenges regarding partnership status or deductibility of certain items;
- d) war or insurrection; and
- e) depression.

Other risks are typical real estate risks which might be associated with certain properties but not with others. To the extent the portfolio is diversified by general partner, by property type, and by geographic location, these risks can be significantly controlled:

- a) overbuilding of a certain property type, resulting in vacancy problems for that market area;
- b) local property tax increases;
- c) the general economic decline of a certain region;
- d) the bankruptcy of a major tenant;
- e) the bankruptcy of the general partner of a particular investment program;
- f) structural deterioration; etc.

3) Interest rate risk. Typically, the market places a value on income real estate in terms of the net operating income (before mortgage payments). This relationship is expressed as a "capitalization rate" or "cap rate". For example, \$100,000 net income capitalized at 10% results in a \$1,000,000 price. If general rates of return required by investors were to rise (because of higher returns available on alternative types of investments), the price would decline, given a fixed net income; an 11% cap rate on \$100,000 would reduce the price to \$909,000, a substantial drop on a leveraged investment. Conversely, a decline in interest rates would increase the market value.

This interest rate risk is particularly devastating to properties where the tenant is on a fixed long-term lease. For example, shopping center properties

on 30 year fixed leases sold at 6.5% cap rates in the early 1960's. In the mid 1970's, that fixed income was capitalized at 9-10%, resulting in a price reduction of one-third of the purchase cost!

4) Market volatility risk. Market prices of real estate tend to change relatively slowly. Only during general cash liquidity squeezes in the economy are there significant increases of sellers vs. buyers, resulting in a temporary decline in real estate values.

5) Liquidity risks. Along with interest rate risk, illiquidity is a common and important risk to deal with. Most of the time, it takes a matter of months to find a buyer willing to pay the "market" price for real property. However, discounts of 5% or so below "market" often result in closing a deal within 60-90 days. Thus, real estate properties do have some liquidity, although at a price.

Probably the period of greatest illiquidity is during times of deflation, when there are no buyers for tangible assets; people would rather hold on to appreciating dollars or fixed-dollar assets. This illiquidity risk can result in a total disaster for many real estate investments during serious periods of deflation/depression.

Compounding the illiquidity issue is the lack of a ready market for most limited partnership shares. If the investment is doing very well, the investor might find a buyer for the shares through either personal contacts or the general partner's contacts. If there is any question about the investment's potential for success, there may be no realistic alternative for the investor except to hold the shares until the partnership is liquidated.

E. CONCLUSION

In summary, the potential for a good total return on real estate investments argues for the assets' inclusion in the investor's portfolio. However, because of the illiquidity risks (which might be associated with a deflationary period), we are unwilling to recommend that clients hold more than a minority percentage of their assets in real estate.

21 · Retirement

OBJECTIVES After studying this chapter, the students should be able to:

- Explain the importance of planning for the financial needs of retirement.
- Plan for their retirement needs and goals.
- Deal with inflation's effect on retirement financial resources.
- Describe the various types of public and private retirement programs.
- Develop strategies to supplement existing retirement programs.

SUGGESTED APPROACH The primary thrust of this chapter is to give students the means of calculating their retirement needs, assessing the contributions made toward fulfillment of these needs by existing retirement programs, and identifying investment plans that can be implemented to make up any projected deficiencies. Therefore, the first task should be to make sure the student understands how to use the planning procedure discussed in the text. (Blank forms are provided in the *Study Guide* for students to use in planning their retirement living expense needs.)

The next step is to familiarize your students with both Social Security (its benefits, how its funds are managed, and what its outlook is) and how the pension plans of major corporations are funded and managed. This can be achieved either as a classroom activity or as an assignment to be carried on outside the classroom. The additional materials and activities for this chapter suggest some ways this might be accomplished.

Finally, this chapter presents a good opportunity for you to have your students use many of the analytical investment skills discussed in Unit IV. (Again, blank forms are provided in the *Study Guide* for students to use in planning their retirement investment needs.) The student-oriented case problem and the Chuck and Nancy Anderson problem at the end of Chapter 21 are good vehicles for this type of analysis and planning. Here is another problem we have found worthwhile to work through in class. It should help students sharpen their newly learned investment planning skills.

The Problem

Jim and Jody Rawlins are both 50. They want to retire in 10 years. Their children are grown and have families of their own, and so the senior Raw-

linses have no financial responsibilities to anyone but themselves. In five years they plan to give each of their five grandchildren \$6,000 to be used for college education expenses. The value of the Rawlinses' investment portfolio is \$125,000. The amount of income they currently contribute toward the buildup of their portfolio is \$7,000—this is after their annual living expenses of \$15,000 and taxes of \$6,000. Their combined annual incomes of \$25,000 are projected to remain level, as is the accompanying tax liability, because Mrs. Rawlins plans to cut back her working time, roughly as inflation increases their income. Their living expenses are expected to increase by 5 percent each year.

Questions

1. How much in additional funds will the Rawlinses be able to contribute to their investment portfolio over the next 10 years?
2. What will this portfolio be worth in 10 years, assuming an annual appreciation of 8 percent?
3. If the Rawlinses contemplate no change in their lifestyle, what will be the level of their living expenses at year 15? At year 20? (Assume 5 percent inflation annually.)
4. What types of investments are best suited to protect the Rawlinses' portfolio against inflation? What risks must be assumed? Are these risks appropriate both before and during retirement? Why? What would be a good general investment strategy for the Rawlinses?

The Answers

1. The Rawlinses will be able to contribute \$22,700.

Determine the effect of inflation on their living expenses and subtract this annual increase from the \$7,000 initially available for investment. The inflation factors are found in Table A at the end of the text.

Year	Living Expenses	5% Increase in Cost of Living	Amount Remaining for Investment
1	\$15,800	\$ 800	\$ 6,200
2	16,500	1,500	5,500
3	17,200	2,200	4,800
4	18,100	3,100	3,900
5	19,000	4,000	3,000
6	20,100	5,100	1,900
7	21,000	6,000	1,000
8	22,100	7,100	(100)
9	23,200	8,200	(1,200)
10	24,300	9,300	(2,300)
Total Contributed to Portfolio			\$22,700

2. Their portfolio will be worth \$316,500 in 10 years.

Use compound interest Table A; however, the progression of factors to be used is reversed. For example, the initial balance of \$125,000 is multiplied by the factor for 8 percent for 10 years. The amount remaining for investment at the end of year 1 (as determined in the answer to the previous question) is multiplied by the factor for 8 percent for 9 years and so on.

Year	Amount ¹	Factor	Value of Portfolio
0	\$125,000	2.2	\$275,000
1	6,200	2.0	12,400
2	5,500	1.8	9,900
3	4,800	1.7	8,200
4	3,900	1.6	6,200
5	3,000	1.5	4,500
6	1,900	1.4	2,700
7	1,000	1.3	1,300
8	(100)	1.2	(100)
9	(1,200)	1.1	(1,300)
10	(2,300)	1.0	(2,300)
Portfolio Final Value			\$316,500

¹ The amount for year 0 is the total value of the portfolio. Amounts for years 1 through 10 are amounts available for investment at the end of those years.

3. The level of their living expenses will be \$31,500 in 15 years.

The factor for 15 years and 5 percent is 2.1 (from compound interest Table A).

$$2.1 \times \$15,000 = \$31,500$$

The level of their living expenses will be \$39,000 in 20 years.

The factor for 20 years and 5 percent is 2.6.

$$2.6 \times \$15,000 = \$39,000$$

4. The types of investments that generally offer a hedge against inflation are equity investments. These include stocks, mutual funds, and real estate. Investments that do not offer such a hedge include savings accounts, bonds, cash-value life insurance, and fixed annuities.

The risk that must be assumed with equity (inflation hedge) investments is that of financial loss: either the income on the investment may not meet expectations or, at the very worst, the entire investment may be lost.

It probably is more appropriate to assume financial risks before rather than during retirement. However, when something as important as a retirement fund is involved, risk should be minimized by selecting relatively conservative equity investments.

A good strategy for the Rawlinses would be to begin with moderately conservative equity investments and move gradually to more conservative investments as they grow older.

1. Have a representative from the local Social Security office speak before your class. The discussion should center around the following aspects of Social Security retirement benefits: how an applicant's qualifications for benefits are verified, how the trust funds from which benefits are paid are managed, and what the outlook for the Social Security program is at present.
2. Have the person in charge of administering the pension plan for a nearby major corporation explain how the employees qualify for retirement benefits, how these benefits are funded, how the retirement funds are managed, and the investment policy of the fund's investment managers (including how much financial risk they are willing to expose the fund to in order to make investments that offset the effects of inflation). He or she might also be asked to comment on how the Employees Retirement Income Security Act of 1974 changed these considerations from what occurred previously.

GUEST LECTURE IDEAS

1. The \$4,000 (\$2,000 or two \$1,000 exemptions for each individual) in personal exemptions available plus the retirement income credit usually shelter this amount of income. (Needless to say, to be eligible to file a joint return and use \$4,000 in exemptions, the retired individuals must be married.)
2. Using compound interest Table A in the text, multiply 3.4 (the factor for 5 percent and 25 years) by \$10,000.
3. If you are under 65 and earn no more than \$3,480 a year (\$290 a month); between 65 and 72 and earn no more than \$350 a month (\$4,500 a year); above 72 there is no maximum (age 70 after 1982).
4. Vesting is a process whereby employees are given a right to retirement benefits based on contributions to a retirement fund made by their employer. Once vested, employees may leave their job and still have a right to retirement benefits from that job when they reach retirement age. (Vesting does not give the employee the right to withdraw their employer's contributions from the fund when they leave a job; they cannot receive anything until they reach retirement age.)

ANSWERS TO CHAPTER QUESTIONS

It is important to consider how your vesting procedure works before deciding to change jobs so that you can time your move in such a way that you won't lose any benefit rights. For example, if an employee became fully vested after 10 years of membership in a retirement program but would be only partially vested with benefit rights before that time, it would be foolish to quit after nine years and nine months of program membership. Staying the additional three months could very well be worth it to become fully vested.

5. A straight life annuity pays benefits solely for the lifetime of the annuitant. A joint-and-survivorship annuity pays benefits to an annuitant and one other person as long as either is alive. (Generally the benefit paid to the survivor is less than that paid while both were alive.)

6. There is a once-in-a-lifetime exclusion of \$100,000 of the gain (\$50,000 on the married taxpayer's return who files separately) realized on the sale of your principal residence.
7. A fixed annuity provides a payment that does not vary in amount. During periods of continuously inflating living costs, the unchanging amount of money received from a fixed annuity buys less and less.
Investments in property, such as stocks or real estate, generally offer hedges against inflation because their value rises with inflation. Variable annuities make payments based on the success of the annuity company's common stock investments and therefore offer better inflation protection than fixed annuities.
8. The most important consideration is advance planning.
9. The retirement income credit is designed to provide a tax break for taxpayers age 65 and older who receive little or no tax-free retirement benefits.
This credit amounts to 15 percent of taxable income up to \$2,500 for single taxpayers and married taxpayers where only one spouse is 65 or older; \$3,750 for married taxpayers both 65 or older filing jointly; and \$1,875 in the latter case but filing separately. For a single person this means a maximum credit of \$228.60, and for a couple \$457.20.
10. The two main effects discussed were the establishment of minimum levels of acceptability for private pension plans and the Pension Benefit Guaranty Corporation.
11. The maximums are \$7,500 and \$1,500 (\$1,750 for a married couple where only one spouse works) for Keoghs and IRAs, respectively.

**ANSWERS AND
DISCUSSION
GUIDE FOR
CASE PROBLEMS**

Student-Oriented Case Problem

1. No. Their investment return would not make up the difference to cover their living expenses if they were to retire today.

A 3 percent after-tax and inflation yield on \$50,000 is only \$1,500. They need \$3,200.

2. No. They probably won't need to pay income taxes on their retirement income.

Because the Meyerses are both 65, they are eligible for four \$1,000 exemptions. When combined with both the retirement income credit and deductions against adjusted gross income, the first \$5,000 to \$6,000 of income is usually free of tax. In the Meyerses' case, the \$3,000 they receive in interest (6 percent on \$50,000) and the \$2,000 in retirement pension payments are the only income items subject to taxation. (Social Security retirement benefits are not subject.)

3. By working until age 70, the Meyerses can achieve a triple benefit. First, they have paid for five more years of their living expenses out of earned income, rather than out of retirement fund assets. Second, because their life expectancies will be less at age 70 than at age 65, they will have fewer years over which they must spread their financial resources; this

reduction should increase the average annual amount available from their savings and corporate bonds. Finally, by working longer, they will probably increase the size of their monthly pension and Social Security benefits.

Chuck and Nancy Anderson Planning for Retirement

1. Chuck's life expectancy at age 65 is 14 years, and Nancy's is 18 years (taken from Table 21-2 in the text). For conservative planning purposes, assume both of them will live to age 85.
2. This is really crystal ball gazing. No one knows for certain. We currently use 5 percent a year for long-term planning purposes, although the average inflation rate since the end of World War II is closer to 4 percent.
3. The aggregate amount Chuck and Nancy will need upon retiring is \$1,548,000.

Multiply the annual living expenses (\$18,000) by the number of years in retirement (20) and then multiply the product by 4.3, the factor from Table A for 30 years—from now to retirement—at 5 percent.

4. The annual amount would be \$36,400.

Assuming 30 years of inflation at 5 percent until the Andersons reach age 65 and assuming that Social Security benefits are raised accordingly, at retirement the annual benefit will be \$28,400 ($\$6,600 \times 4.3$). When added to their pension benefit of \$8,000, which is not expected to increase with inflation, the total is \$36,400.

5. The aggregate value is \$728,000.

Multiply \$36,400 by 20 years of retirement for a total of \$728,000.

6. It falls short of their total needs.

The deficiency is \$820,000 ($\$1,548,000 - \$728,000$).

7. As indicated in the 11-step procedure for Chuck and Nancy in Chapter 15 of the text, \$3,100 is available now as a lump sum for investment for retirement. At 7 percent for 30 years this would be worth \$24,500. In addition, we saw that the Andersons could save at least \$1,500 annually toward retirement or other goals once the furniture is bought in three years. Assuming \$1,000 a year would be invested for retirement, at 7 percent for 27 years, this would amount to \$75,500 ($\$1,000 \times 75.5$). In addition, in later years, as the children's education is completed and they leave home, and as Chuck and Nancy's income rises, they should be able to add progressively greater sums to savings each year.

To this amount can be added the value of their home, provided that the \$18,000 annual living costs for retirement included an allowance for housing expenses. If their home's value has appreciated to \$178,000 in 30 years (4 percent annual appreciation) and the mortgage is paid off, the net proceeds—after selling costs and taxes—should be about \$170,000. Thus, they have identified \$270,000 ($\$170,000 + \$24,500 + \$75,500$) toward their \$820,000 retirement deficit. Although many of

the assumptions about inflation (or deflation) and about investment returns can deviate substantially from reality over the next 30 years, Chuck and Nancy do appear to have their work cut out for them. They should reevaluate this plan every five years, to see how they are progressing. At 15 years from retirement, if the deficit persists, they will have to seriously alter their behavior or their retirement plans or both.

If they are successful and accumulate their fund by age 65, they have one more conservative bias in their favor. The amount not immediately needed for living expenses should continue to earn a return even if it is only invested in savings accounts. The result will be to increase the amount left in the fund each year after they have withdrawn enough to live on.

Objective Questions

SAMPLE TEST QUESTIONS

Circle the letter of the correct answer to each question.

1. Which of the following is an unattractive aspect of retirement?
 - a. Erosion of purchasing power of fixed incomes
 - b. Exhaustion of financial resources providing retirement income
 - c. Inability to maintain one's standard of living on a fixed income
 - d. (All of the above)
2. If you are young, you need NOT begin thinking about retirement now.

True False
3. Which of the following are typical retirement goals?
 - a. Visiting grandchildren
 - b. Travel
 - c. Pursuit of hobbies and interests
 - d. Estate building
 - e. (All of the above)
4. The Bureau of Labor Statistics currently estimates that a medium budget retirement living standard costs
 - a. under \$3,000
 - b. \$3,000-\$4,500
 - c. \$4,500-\$6,000
 - d. \$6,000-\$7,500
 - e. \$7,500-\$9,000
 - f. over \$9,000
5. Which of the following is NOT a form of Social Security benefit?
 - a. Disability payments
 - b. Retirement payments
 - c. Survivors payments
 - d. Child day-care payments
6. Both the hospitalization and medical expense coverage under Medicare are automatic.

True False
7. Under no circumstances may you work while receiving Social Security retirement payments.

True False
8. Which of the following is considered earnings for Social Security purposes?
 - a. Wages, salary, or income derived from self-employment
 - b. Pension payments
 - c. Rents and royalties
 - d. Dividends on stocks
 - e. (All of the above)

9. Social Security retirement benefits may NOT be stopped or reduced simply because you
- a. remarry
 - b. get divorced
 - c. reach age 85
 - d. die
10. Which of the following is a possible form of pension payment option?
- a. Refund annuity
 - b. Guaranteed installment annuity
 - c. Joint-and-survivorship annuity
 - d. Social Security annuity
 - e. (All of the above)
11. Deferred profit-sharing plans may never legally be used as a substitute for a pension plan.

True

False

Essay Questions

1. Give two examples of fixed income and inflation-hedged investments each. Discuss the advantages and disadvantages of each form of investment.
2. Upon retiring, what part of the life cycle will most people find themselves in as regards dependents?
3. What are Keogh plans and IRAs? What is their purpose?

Objective Answers

ANSWERS TO SAMPLE TEST QUESTIONS

1. d
2. F It is never too early to begin doing at least some thinking about what you want during your retirement; this foresight will enable you to decide just when you must implement a plan to achieve your retirement goals.
3. e One should not limit oneself to thinking about only a few goals, but should set all the goals one really wants. They can probably be achieved!
4. d The amount varies within this range from region to region, depending on local living costs.

Point out to your students that they might wish to compare costs for different regions if they plan to live elsewhere during retirement.
5. d
6. F Hospitalization coverage is automatic, but medical expense insurance is voluntary and must be applied for within three months before or after your sixty-fifth, sixty-sixth, sixty-seventh, or sixty-eighth birthday.
7. F You may work while receiving Social Security payments, but only up to certain earnings limits, as discussed in the text.
8. a The other sources of income listed have no effect on Social Security benefits, no matter how much income is derived from them.
9. c The other conditions listed may alter your benefit payments.
10. e The options available to you depend on the details of your particular plan.
11. F There is no such law.

Essay Answers

1. Examples of fixed income investments are savings accounts, fixed annuities, and bonds. These investments have the advantage of being fixed in principal, but because the income payout does not change they are poor inflation hedges. Examples of inflation hedges are real estate, variable annuities, and common stocks. These investments have the prospect of increasing in value with inflation (although no guarantee), but neither their income payout level nor their principal value is assured.
2. Because most people retire between 60 and 70 years of age, it is reasonable to expect their parents to have died and their children to be self-supporting. For people who retire earlier, these circumstances might be different.
3. Keogh plans are a means for self-employed persons to have their own retirement funds. IRAs are individual retirement accounts that employees may set up for themselves when their employer does not offer a

retirement plan. The former allows annual tax-deductible contributions of 15 percent of earned income up to a dollar maximum of \$7,500. The latter allows annual tax-deductible contributions also of 15 percent of earned income, but only up to a dollar maximum of \$1,500 (\$1,750 on a joint account where only one spouse works).

**TRANSPARENCY
MASTER**

These forms are also reproduced in the *Study Guide*.

1. Retirement Living Expense Needs (blank form from text Figure 21-1)
2. Retirement Investment Needs (blank form from text Figure 21-2)

22 · Transferring Your Estate

After studying this chapter, the students should be able to:

OBJECTIVES

- Define the various types of ownership rights.
- Explain what a will can accomplish.
- Explain how the probate process works.
- Explain the ways of partially bypassing the probate process.
- Explain the procedure for computing federal gift taxes and federal estate taxes.
- Describe the appropriate use of trusts, gifts, and joint ownership interests to reduce estate transfer costs.

It is important that the student understand the difference between the two types of expenses involved in estate transfer and the means by which these costs can be reduced.

SUGGESTED APPROACH

1. *Probate and administrative fees.* These expenses include probate court costs, accountant fees, appraisal fees, and legal and executor's fees and expenses. In some instances, these fees are charged on an hourly basis. In other instances, fees are determined as a percentage of the value of assets being probated. If the gross estate less debts equals a certain amount, then a certain small percentage of that amount represents a particular fee. The scale of percentage rates corresponding to gross estates (less debts) is often determined by statute.

The problem with the percentage method of fee determination is that in certain instances there may be little correlation between the fees levied and the value of services rendered. This would make the dollars-per-hour method preferable because with it there is at least some correlation between cost and the number of hours worked. This method assumes, of course, that the proper value of services can be reduced to dollars per hour—and there are many professionals who would quarrel with this assumption.

Nevertheless, there are several methods that can be used to allow certain assets to pass to heirs without going through the probate process. These methods reduce the value (gross estate less debts) on which percentage fees are charged, thus reducing these fees. The most common methods are making gifts, holding joint ownership interests in property, and setting up trusts.

- *Gifts.* Gifts must be made before death; they cannot be made to go into effect when the donor dies. A gift may be made either outright or by means of a living, irrevocable trust. As long as the donor relinquishes total control of the assets given, the gift will be valid.
- *Joint ownership interests.* This form of property ownership prescribes in advance how ownership rights to jointly held assets will be passed on in the event of the death of one of the joint owners. Thus, these assets are not affected by a will and do not pass through the probate process. This is true of joint tenancy and tenancy by the entirety, but not tenancy in common.

- *Trusts.* A gift made by means of a living, irrevocable trust bypasses probate. A living, revocable trust does also. To make this type of trust, an individual (trustor) conveys, while alive, certain assets into a trust by means of a trust agreement and then administers these assets as a trustee. In a trust agreement, there are specific directions for the disposition of these assets upon the trustor/trustee's death. Hence this instrument provides the same dispositive benefits as a will and eliminates the necessity for the trust assets to go through probate.

2. *Taxes.* Whenever ownership rights to assets are transferred to another individual as a gift, a tax may be levied. If the transfer occurs before the donor's death, a gift tax may be incurred. If the transfer occurs at the donor's death, an estate tax may be incurred. The strategies that follow are intended to save on these taxes. It is important to understand that the only effective means of reducing taxes on certain assets is to relinquish ownership rights to those assets and, with them, control of those assets. This is emotionally difficult, if not impossible, for many people to do while they are alive.

- *Gifts.* Whether a gift is made outright or in trust, estate taxes will be avoided on it, although gift taxes may be incurred. If the gift of an income producing asset is made to an individual with a lower marginal income tax bracket than the donor, then the gift's newer owner will pay less income tax on the income produced.

Custodial gifts from a parent to a child where the parent remains the custodian of the gift will be taxed in the estate of the parent. To avoid this, an individual (or individuals) other than the donor/parent should be appointed custodian(s).

- *Trusts.* Trusts can be very confusing to the student. Here are some of the mechanics and timing considerations of different trusts.

a. Living, or *intervivos*, trusts

- The revocable trust's main thrust is the reduction of probate and administrative fees. There is no estate tax savings. No control is lost by the trustor. The person merely administers these assets as trustee rather than owner and may cancel (revoke) the trust at any time.
- The irrevocable trust can never be revoked. Control of the assets by the trustor is lost forever.
- The reversionary, or short-term, trust is irrevocable for a fixed period of time—a minimum of 10 years. After this period has expired, it may be revoked. If the trustor dies during the irrevocable period, however, the assets revert to his or her estate to be taxed and go through probate. The prime benefit of such a trust is that it allows the income on the assets held in the trust to be taxed to the beneficiaries rather than the trustor.

- b. Testamentary trusts are created by wills and do not go into effect until the trustor's death. These, therefore, have no effect on probate fees or estate taxes.

All trust agreements specify how the income and, in certain instances, the principal (corpus) of a trust are to be used for the beneficiaries. The trustees are vested with the fiduciary responsibility of ensuring that these directions are carried out and that the trust assets are managed prudently.

The Chuck and Nancy Anderson case study can be used as a means of explaining the federal estate tax procedure. It is developed to require computations for both a community property and a noncommunity property state. The statement of the problem can be found on the last page of this discussion. We suggest you make copies of it and distribute to your class.

James Weatherby had worked all his life to accumulate a sizable fortune. He was incensed that the federal government (whose activities he generally disapproved of) would take almost half of it in taxes upon his death and again upon the death of his children. Therefore, he devised a trust which (1) held all the estate's assets, net of the taxes on his death; (2) was managed by a corporate trustee to provide continuity; (3) provided lifetime income, but not control of the assets, to his children; and (4) distributed the trust assets to his grandchildren after their parents' death. By doing so, he avoided having his fortune taxed for one generation (upon the death of his children). The taxes saved amounted to \$1,000,000. His heirs hated James for creating the trust, however.

SAMPLE CASE

1. His children resented having to meet with each other annually and more frequently on occasion to handle certain matters brought before them by the corporate trustees. The children were not the best of friends; having to reach a consensus on matters relating to their father's fortune only exacerbated relationships. It was an activity dreaded by all.
2. When the oldest son, John, and his wife died prematurely at age 47 (in an auto crash), their three children, all of whom had reached maturity inherited substantial sums immediately. Their good fortune aroused jealousy in their cousins and their flexibility to do with the money as they pleased aroused envy and frustration in their aunts and uncles.
3. Because the corporate trustee was not a particularly adept investment manager, it managed to lose through poor investment performance substantially more than was saved in taxes by setting up the trust in the first place.

1. Have two practicing estate attorneys come to class to debate the pros and cons of the living, revocable trust as a means of reducing probate and administrative fees. This is an issue not fully agreed upon by all attorneys. (Make sure the objecting attorney is not doing so merely because such trusts represent a loss of substantial probate fees to his or her practice.)

GUEST LECTURE IDEAS

2. Have a bank trust officer explain to your class the services his or her department offers, how they exercise their fiduciary responsibilities, and what their investment management philosophy is. (Is it simply asset conservation or are they trying to increase the value of assets to offset the effects of inflation and, if so, how?) Also, have him or her describe both the duties of trust officers and their fees for serving as executors of an estate.

ANSWERS TO CHAPTER QUESTIONS

1. The types of property that may be included in one's gross estate are as follows: one-half of all community-held property and all of the decedent's separately held property including cash, securities, personal property, accounts receivable, homes, real estate, and the like.
2. Dying intestate means dying without leaving a valid will. When this occurs, the state in which the decedent resided settles the estate according to predetermined dispositive procedures.
3. A will can be used to create trusts, dispose of property to heirs, name guardians for minor children, and appoint executors to administer the decedent's estate.

4. During the probate process the probate court satisfies itself as to the authenticity and legality of the will and the competence of the executor. Then the executor, who is either appointed in the will or by the court, administers the estate according to the instructions of the will. This includes settling debts, paying taxes, and distributing the estate's assets to designated beneficiaries. Prior to distribution, the executor must see that the assets are assembled, preserved, and properly managed.

5. The two major costs of estate transfer are probate and administrative costs, and estate taxes.

Probate and administrative costs are often derived as a percentage of the gross estate less debts. Taxes are a percentage of the taxable estate.

6. An estate tax is levied on the right to transfer property to heirs and is computed on the value of the total estate; an inheritance tax is levied on the right to receive property and is computed on the amount received by each heir.
7. Revocable and reversionary trusts are subject to estate taxation; irrevocable trusts are not.
8. The three forms of joint ownership are joint tenancy, tenancy by the entirety, and tenancy in common.

Joint tenancy is available to two or more owners, each of whom may dispose of his or her share without permission of the other owner(s). Upon the death of one owner, that share passes to the surviving owner(s). Property held in joint tenancy passes outside the probate process.

Tenancy by the entirety is available only to husbands and wives, neither of whom can dispose of his or her share without the other's permission as long as both still live. Upon the death of one spouse, entire ownership of the property becomes vested in the surviving spouse. Property held in tenancy by the entirety passes outside the probate process.

Tenancy in common is available to two or more owners, any one of whom can dispose of his or her share without the permission of the other owner(s). Upon the death of one owner, that share passes to his or her heirs. Property held in tenancy in common is subject to the probate process.

9. If, while still alive, you give away your life insurance policy and all of its rights of ownership, your policy will not be considered part of your estate and you will avoid paying estate taxes on it.

Student-Oriented Case Problem

The estate tax would be \$44,200.

The procedure for arriving at this figure is as follows.

1. To Whitney's taxable estate of \$150,000, add his 1977 taxable gift of \$50,000 for a total of \$200,000.
2. The gross estate tax on \$200,000 (from Table 22-1) is \$54,800.
3. From this amount is subtracted the \$10,600 Whitney paid previously on his 1977 gift of \$50,000.
4. Thus the gross estate tax due on Whitney's \$150,000 taxable estate is \$44,200 (\$54,800 - \$10,600).

ANSWERS AND DISCUSSION GUIDE FOR CASE PROBLEM

Chuck and Nancy Anderson Computing Chuck's Net Estate Tax

The net estate tax liability to the federal government would be \$18,760 in a community property state and \$27,650 in a noncommunity property state.

Items in Tax Computation	Community Property State	Noncommunity Property State
Gross Estate		
Cash	\$ 5,000	\$ 10,000
Securities	37,500	75,000
Home	52,500	105,000
Mutual fund	31,750	63,500
Cars	4,250	8,500
Personal property	12,500	25,000
Real estate investment	28,750	57,500
Total	\$172,250	\$344,500
Deductions		
Funeral expenses	3,500	3,500
Home mortgage balance	750	1,500
Real estate loan	5,000	10,000
Probate and administration fees	15,000	15,000
Total	\$ 24,250	\$ 30,000
Adjusted Gross Estate	\$148,000	\$314,500
Marital Deduction	53,500	220,000
Taxable Estate	94,500	124,500
Gross Estate Tax	22,260	31,150
Credit		
State inheritance tax	3,500	3,500
Net Estate Tax	\$ 18,760	\$ 27,650

**SAMPLE TEST
QUESTIONS**

Objective Questions

Circle the letter of the correct answer to each question.

1. Which of the following is a part of a person's estate?
 - a. Cash
 - b. Life insurance policies
 - c. Personal property
 - d. (All of the above)
2. Intestacy is a legal term defining the period that extends from the time of your death until the time your estate is settled.

True False
3. Which of the following is NOT an advantage of a will?
 - a. Bypasses probate process
 - b. Designates guardians
 - c. Sets up trusts
 - d. Designates executor
4. A good place for keeping your will is your attorney's office.

True False
5. It is NOT always necessary for an executor to be
 - a. trustworthy
 - b. willing to accept the responsibility
 - c. capable of accepting the responsibility
 - d. a personal friend
6. Your executor, when administering your estate, must
 - a. keep detailed records of all transactions
 - b. assemble and preserve all of your property
 - c. have your property inventoried and appraised
 - d. settle all enforceable claims
 - e. (All of the above)
7. When you cause property to bypass the probate process, this property automatically is excluded from your gross estate for federal estate tax purposes.

True False
8. Deductions from gross estate do include
 - a. funeral expenses
 - b. charitable gifts
 - c. enforceable claims
 - d. administrative expenses
 - e. (All of the above)
9. Credits against your gross estate tax include
 - a. charitable gifts
 - b. administrative expenses
 - c. business losses
 - d. state death taxes
 - e. (None of the above)

10. The period for which all trust agreements may remain in force is regulated by law.

True False

11. An ideal trustee should possess

- a. investment expertise
- b. personal interest in your particular trust
- c. guaranteed administrative continuity
- d. no potential for fraudulent abuse of the trust assets
- e. (All of the above)

12. Joint ownership should never be used as an effective substitute for a will.

True False

Essay Questions

1. Summarize the source and form of ownership rights.
2. Summarize the qualities you would look for in a trustee.
3. Summarize the duties of an executor.

**ANSWERS TO
SAMPLE TEST
QUESTIONS**

Objective Answers

1. d
2. F Intestacy is a legal term defining the absence of a valid will.
3. a To be legally valid, a will must go through the probate process.
4. T
5. d It is not always necessary for an executor to be a personal friend; in fact, lack of financial wisdom might make it inadvisable for a personal friend to serve as an executor.
6. e
7. F Most property that bypasses the probate process is still liable for federal estate taxation (unless that property is a gift).
8. e
9. d Charitable gifts, administrative expenses, and businesses losses are not allowable credits.
10. F Charitable trusts may remain in effect indefinitely and are not regulated by state law. All others are regulated.
11. e In reality, personal interest in your particular trust may not always be obtainable in the trustee who can guarantee administrative continuity.
12. T Joint ownership can be used only for certain types of property, whereas a will covers all types of property. Furthermore, wills can accomplish more than just the disposition of assets and are generally easier to revise than are joint ownership agreements.

Essay Answers

1. The sources of ownership rights are separate and community property. There are three forms of ownership: separate property, community property, and joint ownership. The latter can be in one of three forms: joint tenancy, tenancy by the entirety, and tenancy in common.
2. A trustee should be able to provide a personal interest in your trust, investment management expertise, long-term continuity, and integrity. The probability of finding all four qualities in either a personal or corporate trustee is remote, however.
3. An executor does the following:
 - a. Assembles and preserves all of an estate's assets.
 - b. Maintains complete and orderly records of all of the estate's financial transactions.
 - c. Submits a complete inventory of assets and enforceable claims to the appropriate probate authorities.
 - d. Pays all enforceable claims, including income, estate, and inheritance taxes.
 - e. Distributes the estate's assets finally to its beneficiaries.

List of Transparency Masters

- 2-1 Application for Office Position
- 2-2 Personal Data Sheet (application for professional position with a major accounting firm)
- 2-3 Telephone Reference Check
- 2-4 Record of Interviews
- 3-1 Timetable for Financial Decisions
- 3-2 Income Statement (blank form from text Figure 3-2)
- 3-3 Balance Sheet (blank form from text Figure 3-3)
- 4-1 Forecasting Income (blank form from text Figure 4-1)
- 4-2 Forecasting Short-Term Goals (blank form from text Figure 4-3)
- 4-3 Forecasting Long-Term Goals (blank form from text Figure 4-4)
- 4-4 Forecasting Expenses (blank form from text Figure 4-5)
- 4-5 Budget Control Sheet (blank form from text Figure 4-7)
- 6-1 Personal Property Inventory (blank form from text Figure 6-1)
- 6-2 Shopping for Property Insurance (text Figure 6-2)
- 6-3 Sample HO-3 policy
- 6-4 Sample HO-4 policy
- 6-5 Sample floater policy
- 7-1 Shopping for Auto Insurance (text Figure 7-1)
- 8-1 Statement of Income Disability Needs (blank form from text Figure 8-4)
- 8-2 Shopping for Health Insurance (text Figure 8-6)
- 9-1 Eight-Step Procedure (blank form from text Figure 9-1)
- 9-2 Shopping for Life Insurance (text Figure 9-10)
- 11-1 Checkbook ledger (blank form from text Figure 11-2)
- 11-2 Bank statement (blank form from text Figure 11-3)
- 11-3 Statement reconciliation (blank form from text Figure 11-4)
- 12-1 Federal Truth in Lending Disclosure Statement
- 14-1 Borrower's/Buyer's Instructions
- 15-1 Worksheet for Planning Investments and Achieving Goals (blank form from text Figure 15-4)
- 15-2 Overview of Investment Types Treated in Chapters 16 through 20
- 21-1 Retirement Living Expense Needs (blank form from text Figure 21-1)
- 21-2 Retirement Investment Needs (blank form from text Figure 21-2)

Note: All of the transparency masters have also been reproduced in the *Study Guide* except 2-1, 2-2, 2-3, 2-4, 6-4, 6-5, 12-1, and 14-1. In addition, the *Study Guide* contains a copy of a major medical policy, a cash-value life insurance policy, Form 1040, Schedule A, Tax Table A, a lease, and a stock certificate.

APPLICATION FOR OFFICE POSITION

DATE _____

Complete in your own handwriting in ink. If employed, this becomes a part of your Permanent Record.

PERSONAL	PRINT NAME LAST _____ FIRST _____ MIDDLE _____			
	ADDRESS NO. AND STREET _____ CITY _____ STATE _____ ZIP CODE _____ TELEPHONE _____			
	DATE OF BIRTH _____ CITIZEN OF U.S. ☐ YES ☐ NO SOCIAL SECURITY NUMBER _____			
	HAVE YOU EVER BEEN REFUSED OR DO YOU HAVE ANY REASON TO BELIEVE YOU MIGHT BE REFUSED ON APPLICATION FOR A FIDELITY BOND? ☐ YES ☐ NO (If YES, explain in space on back)			
	DO YOU PRESENTLY HAVE ANY EMPLOYMENT COMMITMENT WITH ANOTHER FIRM OR COMPANY? ☐ YES ☐ NO (If YES, explain in space on back)			
POSITION	SPOUSE'S NAME (IF MARRIED) AND EMPLOYER _____			
	PERSON TO NOTIFY IN EMERGENCY NAME _____ TELEPHONE _____ NO. AND STREET _____ CITY _____ STATE _____ ZIP CODE _____			
	POSITION DESIRED _____ STARTING MONTHLY SALARY EXPECTED \$ _____			
	IF YOU PREVIOUSLY APPLIED TO OUR FIRM FOR A POSITION, GIVE YEAR _____ CITY _____			
	WHO REFERRED YOU TO US? _____			
EDUCATION	SCHOLASTIC RECORD —Estimated if not known (We impose no educational requirements beyond those necessary for the position for which the applicant is being considered.)			
	HIGH SCHOOL		COLLEGES (Include Business & Correspondence Schools)	
	NAME _____		NAME _____	
	CITY AND STATE _____		CITY AND STATE _____	
	From _____ To _____ ATTENDED		From _____ To _____ ATTENDED	
	MO. & YR. OF GRAD. _____		DEGREE _____ MO. & YR. OF GRAD. _____	
	☐ UPPER THIRD ☐ MIDDLE THIRD ☐ LOWER THIRD		☐ DAY OR ☐ NIGHT GRADE POINT AVERAGES — Overall _____ English _____ Grade point equivalent of "A" _____	
	of class of _____ NUMBER _____		MAJOR _____	
	COURSE(S) _____		MINOR(S) _____	
	WHAT LANGUAGES OTHER THAN ENGLISH DO YOU SPEAK? _____ READ? _____			
MILITARY	SCHOLARSHIPS AND HONORS _____			
	STATUS WITH U.S. ARMED FORCES—DO YOU HAVE A COMMITMENT TO SERVE IN THE U.S. ARMED FORCES? ☐ YES ☐ NO IF YES, INDICATE PROBABLE CALL DATE _____ FOR _____ MONTHS			
	RECORD IN U.S. ARMED FORCES—BRANCH _____ FROM _____ TO _____ FINAL RANK _____ TYPE DISCHARGE _____ READY RESERVE OBLIGATION FOR _____ MONTHS			
HEALTH	HAVE YOU EVER BEEN TREATED FOR MENTAL ILLNESS? ☐ YES ☐ NO HAVE YOU EVER HAD AN OPERATION? ☐ YES ☐ NO			
	PHYSICAL DEFECTS, IF ANY _____			
	APPROXIMATE TIME LOST THROUGH ILLNESS DURING LAST THREE YEARS _____ NATURE OF ILLNESS _____			
REFERENCES	NAME (Do not include former employers, relatives, or more than one number of college faculty) _____			
	MAILING ADDRESS _____		TITLE OR OCCUPATION _____	
	_____		_____	
	_____		_____	

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RECORD OF PRESENT AND PAST EMPLOYMENT

	LAST OR PRESENT POSITION		NEXT PREVIOUS POSITION		NEXT PREVIOUS POSITION		NEXT PREVIOUS POSITION		NEXT PREVIOUS POSITION	
FROM	MONTH	YEAR	MONTH	YEAR	MONTH	YEAR	MONTH	YEAR	MONTH	YEAR
TO	MONTH	YEAR	MONTH	YEAR	MONTH	YEAR	MONTH	YEAR	MONTH	YEAR
NAME OF COMPANY (OR FULL)										
STREET ADDRESS										
CITY AND STATE										
LINE OF BUSINESS										
POSITION YOU HELD										
DESCRIBE YOUR DUTIES										
NAME OF YOUR SUPERIOR										
SUPERIOR'S TITLE										
MONTHLY SALARY	INITIAL \$	FINAL \$	INITIAL \$	FINAL \$	INITIAL \$	FINAL \$	INITIAL \$	FINAL \$	INITIAL \$	FINAL \$
REASONS FOR LEAVING OR DESIRING TO LEAVE (IF YOU WERE DISCHARGED OR ASKED TO RESIGN, GIVE PARTICULARS.)										
MAY WE CONTACT COMPANY (CIRCLE YES OR NO)	YES	NO	YES	NO	YES	NO	YES	NO	YES	NO

NOTE—ADD ANY SPECIAL REMARKS YOU MAY REGARD AS HELPFUL IN CONSIDERING YOUR APPLICATION.

Routine inquiry will be made as to each individual employed concerning character, general reputation, personal characteristics and mode of living. Additional information with respect to the nature and scope of the inquiry will be provided upon written request.

All representations by me in this data sheet are to the best of my knowledge and belief true and correct and I have not knowingly omitted any related information of an adverse nature.

SIGNATURE

WE ARE AN EQUAL EMPLOYMENT OPPORTUNITY FIRM

Personal Data Sheet

Please complete this personal data sheet. Either present it to the on-campus interviewer or mail to the office in which you are interested

Personal: IF EMPLOYED, THIS BECOMES A PART OF YOUR PERMANENT RECORD

NAME _____
LAST (Please Print) FIRST MIDDLE NICKNAME

PRESENT ADDRESS _____
NO. AND STREET CITY STATE ZIP TELEPHONE, INC. AREA CODE

PERMANENT ADDRESS _____
NO. AND STREET CITY STATE ZIP TELEPHONE, INC. AREA CODE

SOCIAL SECURITY NO. _____

IF NOT A CITIZEN OF U.S. INDICATE TYPE OF VISA _____ ANY PHYSICAL DEFECTS OR RECORD OF MENTAL ILLNESS? ☐ YES ☐ NO ☐
(If YES, explain in Comments Section)

HAVE YOU EVER BEEN REFUSED OR DO YOU HAVE ANY REASON TO BELIEVE YOU MIGHT BE REFUSED ON APPLICATION FOR A FIDELITY BOND? ☐ YES ☐ NO ☐
(If YES, explain in Comments Section)

FATHER'S EMPLOYER AND POSITION _____ MOTHER'S EMPLOYER AND POSITION _____
(When active, if now retired or deceased) (When active, if now retired or deceased)

Education: SCHOLASTIC RECORD TO DATE (Estimate if Not Known)—

HIGH SCHOOL	UNDERGRADUATE		GRADUATE				
NAME _____	UNIVERSITY _____	UNIVERSITY _____	UNIVERSITY _____				
CITY AND STATE _____	CITY AND STATE _____	CITY AND STATE _____	CITY AND STATE _____				
MO. AND YR. OF GRADUATION _____	FROM _____ TO _____ ATTENDED	FROM _____ TO _____ ATTENDED	FROM _____ TO _____ ATTENDED				
I stood number _____ scholastically in a class of _____, or estimate that I stood in the top 10% ☐ 25% ☐ 50% ☐ 75% ☐	DEGREE _____ MO. & YR. OF GRAD. _____	DEGREE _____ MO. & YR. OF GRAD. _____	DEGREE _____ MO. & YR. OF GRAD. _____				
CONCENTRATION OR MAJOR _____	CONCENTRATION OR MAJOR _____	CONCENTRATION OR MAJOR _____	CONCENTRATION OR MAJOR _____				
GRADE POINT AVERAGES— Overall _____ Accounting _____ Grade point equivalent of "A" _____	GRADE POINT AVERAGES— Overall _____ Accounting _____ Grade point equivalent of "A" _____	GRADE POINT AVERAGES— Overall _____ Accounting _____ Grade point equivalent of "A" _____	GRADE POINT AVERAGES— Overall _____ Accounting _____ Grade point equivalent of "A" _____				
COLLEGE BOARD S.A.T. SCORES (200-800 Range) Verbal _____ Math _____							
INSERT IN THE APPROPRIATE BOXES THE NUMBER OF HOURS OF COLLEGE CREDITS, BROKEN DOWN BY GRADES AND SUBJECTS AS INDICATED	GRADES	NUMBER OF HOURS		NUMBER OF HOURS		NUMBER OF HOURS	
		ACCTG.	ENGLISH	ALL OTHER	ACCTG.	ENGLISH	ALL OTHER
	A or B						
	C						
	D or Lower						
	Unit of Hours	Semester or Quarter		Semester or Quarter		Semester or Quarter	

TOTAL HOURS OF ACCOUNTING UPON COMPLETION OF FINAL DEGREE _____ APPROXIMATE NUMBER OF HOURS PER WEEK OF OUTSIDE EMPLOYMENT DURING THIS ACADEMIC YEAR _____

TEST RESULTS, IF TAKEN—

Graduate Management Admission Test—

VERBAL _____ QUANTITATIVE _____
(0-60) (0-60)

TOTAL _____
(200-800)

Graduate Record Examination—

VERBAL _____ QUANTITATIVE _____
(200-900) (200-900)

ADVANCED _____
(Subject) (200-990)

Law School Admission Tests—

WRITING _____ BACKGROUND _____
(20-80) (20-80)

LSAT _____
(200-800)

HAVE YOU PASSED THE CPA EXAMINATION? YES ☐ NO ☐ IF YES, IN WHAT STATE? _____

SCHOLARSHIPS _____

HONORS Beta Alpha Psi ☐ Beta Gamma Sigma ☐ Phi Beta Kappa ☐ Other _____

PARTICIPATION IN SCHOOL ACTIVITIES (e.g., class organizations, athletics, publications) _____

COLLEGE _____

HIGH SCHOOL _____

(OVER)

Military:

Status with U.S. Armed Forces—

Do you have a commitment to serve in the U.S. Armed Forces? YES ☐ NO ☐

If you, indicate probable call date _____ for _____ months.

Record in U.S. Armed Forces—

Branch _____ Date Entered _____ Date Discharged _____ Final Rank _____

Did you receive a dishonorable discharge? YES ☐ NO ☐**Position Interests:**Have you previously applied to our firm for a position? YES ☐ NO ☐ If YES, _____ Year _____ and _____ Office _____Do you now have any employment commitment with another firm or company? YES ☐ NO ☐ (If YES, explain in Comments Section)Are you primarily interested in Accounting and Auditing? ☐ Taxes ☐ Administrative Services ☐

Location Preference—Our firm representatives are seeking qualified personnel for all offices of our firm. The U.S. office locations are listed in our brochure. Please indicate your location preferences below:

1st Choice _____ 2nd Choice _____ 3rd Choice _____

Who referred you to us? _____

How much travel of short duration would you accept? 10% ☐ 25% ☐ More than 25% ☐ Starting annual salary expected _____**Employment Record:**

SPECIFICS—>	LAST OR PRESENT POSITION	NEXT PREVIOUS POSITION	NEXT PREVIOUS POSITION
EMPLOYER—>			
ADDRESS—>			
NATURE OF DUTIES—>			
IMMEDIATE SUPERVISOR—>			
PERIOD—MONTH AND YEAR—>	FROM _____ TO _____	FROM _____ TO _____	FROM _____ TO _____
FINAL MONTHLY SALARY—>			
DISCHARGED OR ASKED TO RESIGN—>	NO ☐ YES ☐	NO ☐ YES ☐	NO ☐ YES ☐
MAY WE CONTACT EMPLOYER—>	YES ☐ NO ☐	YES ☐ NO ☐	YES ☐ NO ☐

References: (DO NOT INCLUDE FORMER EMPLOYERS, RELATIVES OR MORE THAN ONE MEMBER OF COLLEGE FACULTY)

NAME	BAILING ADDRESS	TITLE OR OCCUPATION	YEARS KNOWN
1. _____			
2. _____			
3. _____			

Comments: USE THIS SPACE FOR ANY FURTHER EXPLANATIONS OR INFORMATION YOU WISH TO SUPPLY.

Routine inquiry will be made as to each individual employed concerning character, general reputation, personal characteristics and mode of living. Additional information with respect to the nature and scope of the inquiry will be provided upon written request.

All representations by me in this data sheet are to the best of my knowledge and belief true and correct and I have not knowingly omitted any related information of an adverse nature.

Date _____ Signature _____

We Are An Equal Employment Opportunity Firm

© 1980 SRA

TELEPHONE REFERENCE CHECK

Made By _____ Date _____

NAME OF APPLICANT _____

COMPANY CONTACTED _____

NAME AND TITLE OF PERSON CONTACTED _____

Mr./Ms. _____ is an applicant for employment with our

Company. We would like to check some information he/she has given us.

Do you recall about when he/she started with your Company? _____

and when he/she left? _____

What was his/her job? _____

Date of Birth _____ SS# _____

He/She indicates his/her earnings were _____ Is this Correct? _____

How was his/her performance on the job? _____

Skills (if applicable) _____

Can you tell me why he/she left? _____

Would you re-employ him/her? _____

How did he/she get along with others on the job? _____

Cooperative? _____

How was his/her attendance? _____

Character? _____

Other Pertinent Information _____

RECORD OF INTERVIEWS

[illegible]

TIMETABLE FOR FINANCIAL DECISIONS

Month	Insurance				Budgeting	Tax	Housing	Investments		
	Property	Auto	Health	Life				General	Stocks and Bonds	Mutual Funds
January										
February										
March										
April										
May										
June										
July										
August										
September										
October										
November										
December										

NAME(S) _____
FOR THE YEAR BEGINNING JAN. 1, _____ AND ENDING DEC. 31, _____

INCOME STATEMENT

1 *Income*

Wages or salary	
Husband	_____
Wife	_____
Dividends and interest	_____
Capital gains and losses (e.g., from sale of stock)	_____
Rents, annuities, pensions, and such	_____
Other _____	_____

2 *TOTAL INCOME*

3 *Taxes*

Personal income taxes	_____
Social Security and disability taxes	_____

4 *TOTAL TAXES*

5 *Amount Remaining for*

Living Expenses and Investment

6 *Living Expenses*

Fixed Variable

Housing		
Utilities	_____	_____
Repairs	_____	_____
Insurance	_____	_____
Taxes	_____	_____
Rent or mortgage payments	_____	_____
Other _____	_____	_____
Food	_____	_____
Clothing (including laundry, dry cleaning, repair, and personal effects)	_____	_____
Transportation		
Gas	_____	_____
Repairs	_____	_____
Licenses	_____	_____
Insurance	_____	_____
Auto payments or purchase	_____	_____
Recreation, entertainment, and vacations	_____	_____
Medical		
Doctor	_____	_____
Dentist	_____	_____
Medicines	_____	_____
Insurance	_____	_____
Personal	_____	_____
Life insurance	_____	_____
Outlays for fixed assets	_____	_____
Other expenses _____	_____	_____

SUBTOTAL

7 *TOTAL ANNUAL LIVING EXPENSES*

8 *Amount Remaining for Savings and Investment*

NAME(S) _____
 DATE _____

BALANCE SHEET

ASSETS		LIABILITIES	
MONETARY ASSETS		12 Unpaid Bills	
1 Cash		Taxes	_____
On hand	_____	Insurance	_____
Checking account	_____	premiums	_____
Savings account	_____	Rent	_____
TOTAL CASH	_____	Utilities	_____
2 Money loaned to others		Charge accounts	_____
(repayment expected)	_____	Other	_____
3 Investments		TOTAL UNPAID BILLS	_____
Savings bonds	_____	13 Installment Loans (balance due)	
Stocks and bonds	_____	Automobile	_____
Mutual funds	_____	Other	_____
Cash value of		TOTAL	_____
life insurance	_____	14 Loans (balance)	
Cash value of		Bank	_____
annuities	_____	Education	_____
Cash value of		Other	_____
retirement fund	_____	TOTAL	_____
TOTAL INVESTMENTS	_____	15 Mortgage Loans (balance due)	
4 TOTAL MONETARY ASSETS	=====	Home	_____
FIXED ASSETS		Other	_____
5 Home and property	_____	TOTAL	_____
6 Investments		16 TOTAL LIABILITIES	=====
Other real estate	_____	17 NET WORTH	_____
Retirement fund	_____	18 LIABILITIES AND NET WORTH	=====
7 Automobiles	_____		
8 Ownership interests			
in small businesses	_____		
9 Personal property	_____		
10 TOTAL FIXED ASSETS	=====		
11 TOTAL ASSETS OF FAMILY	=====		

NAME(S) _____

DATE _____

FORECASTING INCOME

Source	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Estimated 12-Month Total	Average Per Month	Actual Year's Income
Husband's take-home wages or salary															
Wife's take-home wages or salary															
Bonuses or commissions															
Interest															
Dividends															
Rents															
Annuities, pensions															
Other															
TOTAL															

DATE _____

[illegible]

NAME(S) _____			
DATE _____			
FORECASTING			
Expense Category	Fixed and Variable Subcategories	Jan.	Feb.
Housing	Rent, mortgage payments, insurance, and taxes		
	Repairs and improvements		
Utilities			
Food			
Family necessities			
Medical	Insurance		
	Doctor, dentist, drugs, and hospital		
Clothing			
Automobile	Purchase payments, insurance and license fees		
	Gas, oil, repairs, parking, tolls, and so on		
Recreation and entertainment	General		
Personal improvement	Magazines and newspapers		
	Books and tuition		
Short-term goal fund			
Savings and investment	For long-term goals		
Outlays for fixed assets	Repairs		
	Purchases and installments		
Mad money			
Gifts			
Church and charity			
Life insurance			
Taxes			
Contingency	Legal services, debt repayments, union dues		
TOTAL BY MONTH			

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EXPENSES

[illegible]

NAME(S) _____
 DATE _____

BUDGET CONTROL SHEET

Expense Category	Budgeted Monthly Average	Month:		Month:			Revised Monthly Average	Month:			Month:		
		Actual	Plus or Minus	Balance Forward	Actual	Plus or Minus		Balance Forward	Actual	Plus or Minus	Balance Forward	Actual	Plus or Minus
Housing													
Utilities													
Food													
Family necessities													
Medical													
Clothing													
Automobile													
Recreation and entertainment													
Personal improvement													
Short-term goal fund													
Savings and investment													
Outlays on fixed assets													
Mad money													
Gifts													
Church and charity													
Life insurance													
Taxes													
Contingency													
TOTAL													

PERSONAL PROPERTY INVENTORY

1 Article Category	2 Number of Articles	3 Total Original Cost	4 Average Age (Years)	5 Annual Depreciation	6 Total Depreciation	7 Today's Cost	8 Accumulated Dollar Depreciation	9 Market Value
TOTAL								

SHOPPING FOR PROPERTY INSURANCE

	<i>Insurer 1</i>	<i>Insurer 2</i>	<i>Insurer 3</i>
Policy type			
Company			
Renewal date			
	<i>Limits</i>	<i>Premiums</i>	
Home			
Detached buildings			
Trees, shrubs, plants			
Personal property on premises			
Personal property off premises			
Additional living expenses			
Comprehensive personal liability ^a			
Medical expense payments ^a			
Scheduled items			
Endorsements			
Extended theft			
Inflation guard			
Replacement cost			
Other (e.g., earthquake, flood)			
Deductible			
Total annual premium			

^aFor explanation of these categories, see Chapter 7.

DECLARATIONS CALIFORNIA HOMEOWNERS POLICY

This Declarations Page, the Forms and Endorsements issued to form a part of the policy, and the provisions contained on Pages 2 through 8, complete the below numbered Homeowners Policy.

NAMED INSURED & ADDRESS (No., Street, Town or City, County, State, Zip)

Policy Term Years	Policy Number
Policy Period: Inception Expiration	

The described residence premises covered hereunder is located at the above address unless otherwise stated herein (No., Street, Town or City, County, State, Zip)

Insurance is provided only with respect to the following Coverages for which a limit of liability is specified, subject to all conditions of this policy.

COVERAGES AND LIMITS OF LIABILITY	SECTION I				SECTION II	
	A. Dwelling	B. Apartment Structures	C. Unscheduled Personal Property	D. Additional Living Expense	E. Personal Liability (Bodily Injury and Property Damage) Each Occurrence	F. Medical Payments to Others Each Person Each Accident
	\$	\$	\$	\$	\$	\$
FORMS AND ENDORSEMENTS						
PREMIUM	Basic Policy Premium	Other	EQ	TOTAL PREPAID	If Paid on Installment	TOTAL
PREPAID	\$	\$	\$	\$	\$	\$
DEDUCTIBLE — SECTION I: Any loss of perils insured against under Section I of this policy is subject to a deductible. Exceptions if any: ☐ Deductible applicable only to loss caused by the peril of windstorm or hail (Clause No. 1). ☐ Deductible applicable to loss caused by other perils (Clause No. 2). ☐ Deductible not applicable ☐ Special Loss Deductible Clause \$						
SPECIAL STATE PROVISIONS Minnesota — Insurable Value of Dwelling \$ South Carolina — Valuation Clause (Coverage A) \$ New York Coinurance Clause Applies ☐ Yes ☐ No						
SECTION II — Additional residence premises, if any, located: (Number, Street, Town or City, County, State, Zip)						
MORTGAGEE(S) (Name and Address)						

Countersignature Date

Agency at

Agent

In Consideration of the Provisions and Stipulations Herein or Added Hereto and of the Premium Above Specified (or specified in endorsement(s) made a part hereof), this Company, indicated above by ☐, for the term shown above from inception date shown above at 12:01 a.m. (Standard Time) to expiration date shown above at 12:01 a.m. (Standard Time) at location of property involved, to an amount not exceeding the limit of liability above specified, does insure the Insured named in the Declarations above and legal representatives, to the extent of the actual cash value of the property at the time of loss, but not exceeding the amount which it would cost to repair or replace the property with material of like kind and quality within a reasonable time after such loss, without allowance for any increased cost of repair or reconstruction by reason of any ordinance or law regulating construction or repair, and without compensation for loss resulting from interruption of business or manufacture, nor in any event for more than the interest of the insured, against all DIRECT LOSS BY FIRE, LIGHTNING AND OTHER PERILS INSURED AGAINST IN THIS POLICY INCLUDING REMOVAL FROM PREMISES ENDANGERED BY THE PERILS INSURED AGAINST IN THIS POLICY, EXCEPT AS HEREINAFTER PROVIDED, to the property described herein while located or contained as described in this policy, or pro rata for five days at each proper place to which any of the property shall necessarily be removed for preservation from the perils insured against in this policy, but not elsewhere.

Assignment of this policy shall not be valid except with the written consent of this Company.

This policy is made and accepted subject to the foregoing provisions and stipulations and those hereinafter stated, which are hereby made a part of this policy, together with such other provisions, stipulations and agreements as may be added hereto, as provided in this policy.



HOMEOWNERS POLICY — SPECIAL FORM
This form is void unless HO-Section II is attached
SECTION I

HO-3
(Ed. 8-71)
California

DESCRIPTION OF PROPERTY AND INTERESTS COVERED

COVERAGE A — DWELLING

This policy covers the described dwelling building, including additions in contact therewith, occupied principally as a private residence.

This coverage also includes:

1. if the property of the Insured and when not otherwise covered, building equipment, fixtures and outdoor equipment all pertaining to the service of the premises and while located thereon or temporarily elsewhere; and
2. materials and supplies located on the premises or adjacent thereto, intended for use in construction, alteration or repair of such dwelling.

COVERAGE B — APPURTENANT STRUCTURES

This policy covers structures (other than the described dwelling building, including additions in contact therewith) appertaining to the premises and located thereon.

This coverage also includes materials and supplies located on the premises or adjacent thereto, intended for use in construction, alteration or repair of such structures.

THIS COVERAGE EXCLUDES:

1. STRUCTURES USED IN WHOLE OR IN PART FOR BUSINESS PURPOSES; OR
2. STRUCTURES RENTED OR LEASED IN WHOLE OR IN PART OR HELD FOR SUCH RENTAL OR LEASE (EXCEPT STRUCTURES USED EXCLUSIVELY FOR PRIVATE GARAGE PURPOSES) TO OTHER THAN A TENANT OF THE DESCRIBED DWELLING.

COVERAGE C — UNSCHEDULED PERSONAL PROPERTY

This policy covers unscheduled personal property usual or incidental to the occupancy of the premises as a dwelling and owned or used by an Insured, while on the described premises and, at the option of the Named Insured, owned by others while on the portion of the premises occupied exclusively by the Insured.

This coverage also includes such unscheduled personal property while elsewhere than on the described premises, anywhere in the world:

1. owned or used by an Insured; or
2. at the option of the Named Insured,
 - a. owned by a guest while in a residence occupied by an Insured; or
 - b. owned by a residence employee while actually engaged in the service of an Insured and while such property is in the physical custody of such residence employee or in a residence occupied by an Insured;
3. but the limit of this Company's liability for the unscheduled personal property away from the premises shall be an additional amount of insurance equal to 10% of the amount specified for Coverage C, but in no event less than \$1,000.

THIS COVERAGE EXCLUDES:

1. ANIMALS, BIRDS OR FISH;
2. MOTORIZED VEHICLES, EXCEPT SUCH VEHICLES PERTAINING TO

THE SERVICE OF THE PREMISES AND NOT LICENSED FOR ROAD USE;

3. AIRCRAFT;
4. PROPERTY OF ROOMERS AND BOARDERS NOT RELATED TO THE INSURED;
5. PROPERTY CARRIED OR HELD AS SAMPLES OR FOR SALE OR FOR DELIVERY AFTER SALE;
6. PROPERTY RENTED OR HELD FOR RENTAL TO OTHERS BY THE INSURED, EXCEPT PROPERTY CONTAINED IN THAT PORTION OF THE DESCRIBED PREMISES CUSTOMARILY OCCUPIED EXCLUSIVELY BY THE INSURED AND OCCASIONALLY RENTED TO OTHERS OR PROPERTY OF THE INSURED IN THAT PORTION OF THE DESCRIBED DWELLING OCCUPIED BY ROOMERS OR BOARDERS;
7. BUSINESS PROPERTY WHILE AWAY FROM THE DESCRIBED PREMISES;
8. ANY DEVICE OR INSTRUMENT FOR THE RECORDING, REPRODUCTION OR RECORDING AND REPRODUCTION OF SOUND WHICH MAY BE OPERATED BY POWER FROM THE ELECTRICAL SYSTEM OF A MOTOR VEHICLE, OR ANY TAPE, WIRE, RECORD DISC OR OTHER MEDIUM FOR USE WITH ANY SUCH DEVICE OR INSTRUMENT WHILE ANY OF SAID PROPERTY IS IN OR UPON A MOTOR VEHICLE; OR
9. PROPERTY WHICH IS SEPARATELY DESCRIBED AND SPECIFICALLY INSURED IN WHOLE OR IN PART BY THIS OR ANY OTHER INSURANCE.

COVERAGE D — ADDITIONAL LIVING EXPENSE

If a property loss covered under this policy renders the premises untenable, this policy covers the necessary increase in living expense incurred by the Named Insured to continue as nearly as practicable the normal standard of living of the Named Insured's household FOR NOT EXCEEDING THE PERIOD OF TIME REQUIRED:

1. TO REPAIR OR REPLACE SUCH DAMAGED OR DESTROYED PROPERTY AS SOON AS POSSIBLE; OR
2. FOR THE NAMED INSURED'S HOUSEHOLD TO BECOME SETTLED IN PERMANENT QUARTERS; WHICHEVER IS LESS.

This coverage also includes:

1. the fair rental value of any portion of the described dwelling or appurtenant structures covered under this policy, as furnished or equipped by the Named Insured, which is rented or held for rental by the Named Insured. THE FAIR RENTAL VALUE SHALL NOT INCLUDE CHARGES AND EXPENSES THAT DO NOT CONTINUE DURING THE PERIOD OF UNTENABILITY. COVERAGE SHALL BE LIMITED TO THE PERIOD OF TIME REQUIRED TO RESTORE, AS SOON AS POSSIBLE, THE RENTED PORTION TO THE SAME TENANTABLE CONDITION;
2. the period of time, NOT EXCEEDING TWO WEEKS, while access to the premises is prohibited by order of civil authority, as a direct result of damage to neighboring premises by a peril not otherwise excluded.

The periods described above shall not be limited by the expiration of this policy.

THIS COVERAGE EXCLUDES EXPENSE DUE TO CANCELLATION OF ANY LEASE, OR ANY WRITTEN OR ORAL AGREEMENT.

SUPPLEMENTARY COVERAGES

The following supplementary coverages SHALL NOT INCREASE THE APPLICABLE LIMIT OF LIABILITY UNDER THIS POLICY:

1. Automatic Removal: If, during the term of this policy, the Named Insured removes unscheduled personal property covered under Coverage C from the premises to another location within the Continental United States or the State of Hawaii, to be occupied as his principal residence, the limit of liability for Coverage C shall apply at each location in the proportion that the value at each location bears to the total value of all such property covered under Coverage C.

PROPERTY IN TRANSIT SHALL BE SUBJECT TO THE LIMIT OF LIABILITY FOR UNSCHEDULED PERSONAL PROPERTY AWAY FROM THE PREMISES.

This coverage shall apply ONLY FOR A PERIOD OF 30 DAYS from the date removal commences and shall then cease.

2. Debris Removal: This policy covers expenses incurred in the removal of all debris of the property covered hereunder, occasioned by loss thereto for which coverage is afforded.

3. Fire Department Service Charge: This policy covers for an amount NOT EXCEEDING \$250 the Named Insured's liability, assumed by contract or agreement for fire department charges where fire department is called because of a fire in, on or exposing property insured hereunder, while located on the premises described. THIS COVERAGE DOES NOT COVER NAMED INSURED'S LIABILITY, BY CONTRACT OR OTHERWISE, TO INDEMNIFY EITHER A CITY, MUNICIPALITY OR FIRE PROTECTION DISTRICT, OR ANY OTHER PERSON, FIRM OR CORPORATION AGAINST LOSS, CLAIM OR LIABILITY ARISING BY REASONS OF THE MOVEMENT OR FUNCTIONING OF FIRE APPARATUS OR MEMBERS OF A FIRE DEPARTMENT; OR BY REASON OF ANY ACCIDENT ARISING OUT OF THE PERFORMANCE OF SERVICES BY ANY FIRE DEPARTMENT. COVERAGE AFFORDED UNDER THIS CLAUSE APPLIES ONLY IF THE PROPERTY IS NOT LOCATED WITHIN THE LIMITS OF THE CITY, MUNICIPALITY OR FIRE PROTECTION DISTRICT FURNISHING SUCH FIRE DEPARTMENT RESPONSE.

DEDUCTIBLE

Loss Deductible Clause: WITH RESPECT TO LOSS COVERED UNDER THIS POLICY, THIS COMPANY SHALL BE LIABLE ONLY WHEN SUCH LOSS IN EACH OCCURRENCE EXCEEDS \$100 AND THEN ONLY FOR THE AMOUNT OF

SUCH EXCESS.

THIS LOSS DEDUCTIBLE CLAUSE SHALL NOT APPLY TO COVERAGE D—ADDITIONAL LIVING EXPENSE OR FIRE DEPARTMENT SERVICE CHARGE.

PERILS INSURED AGAINST

This policy insures under:

COVERAGE A—DWELLING and **COVERAGE B—APPURTENANT STRUCTURES** against all risks of physical loss to the property covered (and under **COVERAGE D, ADDITIONAL LIVING EXPENSE** resulting from such loss), EXCEPT AS OTHERWISE EXCLUDED OR LIMITED.

COVERAGE C—UNSCHEDULED PERSONAL PROPERTY against direct loss to the property covered by the following perils AS DEFINED AND LIMITED, EXCEPT AS OTHERWISE EXCLUDED:

1. Fire or Lightning.

2. Removal, meaning direct loss by removal of the property covered hereunder from premises endangered by the perils insured against. The applicable limit of liability, had the property not been removed, applies pro rata for 30 days at each proper place to which any of the property shall necessarily be removed for preservation from or for repair of damages caused by the perils insured against.

3. Windstorm or Hail, EXCLUDING LOSS:

a. CAUSED DIRECTLY OR INDIRECTLY BY FROST OR COLD WEATHER OR ICE (OTHER THAN HAIL), SNOW OR SLEET, ALL WHETHER DRIVEN BY WIND OR NOT;

b. CAUSED BY RAIN, SNOW, SAND OR DUST, ALL WHETHER DRIVEN BY WIND OR NOT, UNLESS THE BUILDING CONTAINING THE PROPERTY COVERED SHALL FIRST SUSTAIN AN ACTUAL DAMAGE TO ROOF OR WALLS BY THE DIRECT FORCE OF WIND OR HAIL AND THEN THIS COMPANY SHALL BE LIABLE FOR LOSS TO THE PROPERTY COVERED THEREIN CAUSED BY RAIN, SNOW, SAND OR DUST ENTERING THE BUILDING THROUGH OPENINGS IN THE ROOF OR WALLS MADE BY DIRECT ACTION OF WIND OR HAIL; OR

c. TO WATERCRAFT (EXCEPT ROWBOATS AND CANOES ON PREMISES) INCLUDING THEIR TRAILERS, FURNISHINGS, EQUIPMENT AND OUTBOARD MOTORS WHILE SUCH PROPERTY IS NOT INSIDE FULLY ENCLOSED BUILDINGS.

4. Explosion.

5. Riot or Civil Commotion, including direct loss from pillage and looting occurring during and at the immediate place of a riot or civil commotion.

6. Aircraft, including self-propelled missiles and spacecraft.

7. Vehicles.

8. Sudden and accidental damage from smoke, OTHER THAN SMOKE FROM AGRICULTURAL SMOKING OR INDUSTRIAL OPERATIONS.

9. Vandalism or Malicious Mischief, MEANING ONLY THE WILFUL AND MALICIOUS DAMAGE TO OR DESTRUCTION OF THE PROPERTY COVERED.

10. Theft, meaning any act of stealing or attempt thereof, including loss of property from a known place under circumstances when a probability of theft exists.

Unscheduled personal property contained in any bank, trust or safe deposit company, public warehouse or occupied dwelling not owned or occupied by or rented to an insured in which the property covered has been placed for safekeeping shall be considered as being on the described premises.

UPON KNOWLEDGE OF LOSS UNDER THIS PERIL OR OF AN OCCURRENCE WHICH MAY GIVE RISE TO A CLAIM FOR SUCH LOSS, THE INSURED SHALL GIVE IMMEDIATE NOTICE TO THIS COMPANY OR ITS AUTHORIZED AGENTS AND ALSO TO THE POLICE.

a. GENERAL THEFT EXCLUSIONS:

THIS POLICY DOES NOT APPLY TO LOSS:

(1) IF COMMITTED BY AN INSURED;

(2) IN OR TO A DWELLING UNDER CONSTRUCTION OR OF MATERIALS OR SUPPLIES THEREFOR UNTIL COMPLETED AND OCCUPIED;

(3) ARISING OUT OF OR RESULTING FROM THE THEFT OF ANY CREDIT CARD OR LOSS BY FORGERY OR ALTERATIONS OF ANY CHECK, DRAFT, PROMISSORY NOTE, BILL OF EXCHANGE, OR SIMILAR WRITTEN PROMISE, ORDER OR DIRECTION TO PAY A SUM CERTAIN IN MONEY; OR

(4) OF A PRECIOUS OR SEMI-PRECIOUS STONE FROM ITS SETTING.

b. THEFT EXCLUSIONS APPLICABLE WHILE THE DESCRIBED DWELLING IS RENTED TO OTHERS:

THIS POLICY DOES NOT APPLY TO LOSS FROM THE DESCRIBED DWELLING WHILE THE PORTION OF THE DESCRIBED DWELLING CUSTOMARILY OCCUPIED EXCLUSIVELY BY AN INSURED IS RENTED TO OTHERS:

(1) OF MONEY, BULLION, NUMISMATIC PROPERTY OR BANK NOTES;

(2) OF SECURITIES, ACCOUNTS, BILLS, DEEDS, EVIDENCES OF DEBT, LETTERS OF CREDIT, NOTES OTHER THAN BANK NOTES, PASSPORTS, RAILROAD AND OTHER TICKETS OR STAMPS, INCLUDING PHILATELIC PROPERTY;

(3) OF JEWELRY, WATCHES, NECKLACES, BRACELETS, GEMS, PRECIOUS AND SEMI-PRECIOUS STONES; ARTICLES OF GOLD AND PLATINUM; OR ANY ARTICLE OF FUR OR ARTICLE CONTAINING FUR WHICH REPRESENTS ITS PRINCIPAL VALUE; OR

(4) CAUSED BY A TENANT, HIS EMPLOYEES OR MEMBERS OF HIS HOUSEHOLD WHILE RENTING THE PORTION OF THE DESCRIBED DWELLING CUSTOMARILY OCCUPIED EXCLUSIVELY BY AN INSURED.

c. THEFT EXCLUSIONS APPLICABLE TO PROPERTY AWAY FROM THE DESCRIBED PREMISES:

THIS POLICY DOES NOT APPLY TO LOSS AWAY FROM THE DESCRIBED PREMISES OF:

(1) PROPERTY WHILE IN ANY DWELLING OR PREMISES THEREOF, OWNED, RENTED OR OCCUPIED BY AN INSURED, EXCEPT WHILE AN INSURED IS TEMPORARILY RESIDING THEREIN;

(2) PROPERTY WHILE UNATTENDED IN OR ON ANY MOTOR VEHICLE OR TRAILER, OTHER THAN A PUBLIC CONVEYANCE, UNLESS THE LOSS IS THE RESULT OF FORCIBLE ENTRY INTO SUCH VEHICLE WHILE ALL DOORS, WINDOWS OR OTHER OPENINGS THEREOF ARE CLOSED AND LOCKED, PROVIDED THERE ARE VISIBLE MARKS OF FORCIBLE ENTRY UPON THE EXTERIOR OF SUCH VEHICLE OR THE LOSS IS THE RESULT OF THE THEFT OF SUCH VEHICLE WHICH IS NOT RECOVERED WITHIN 30 DAYS, BUT PROPERTY SHALL NOT BE CONSIDERED UNATTENDED WHEN THE INSURED IS REQUIRED TO SURRENDER THE KEYS OF SUCH VEHICLE TO A BAILEE;

(3) PROPERTY WHILE UNATTENDED IN OR ON PRIVATE WATERCRAFT UNLESS THE LOSS IS THE DIRECT RESULT OF FORCIBLE ENTRY INTO A SECURELY LOCKED COMPARTMENT AND PROVIDED THERE ARE VISIBLE MARKS OF FORCIBLE ENTRY UPON THE EXTERIOR OF SUCH COMPARTMENT;

(4) WATERCRAFT, THEIR FURNISHINGS, EQUIPMENT AND OUTBOARD MOTORS; OR

(5) TRAILERS, WHETHER LICENSED OR NOT.

11. Falling objects, BUT EXCLUDING LOSS TO PROPERTY WITHIN A BUILDING, UNLESS THE BUILDING CONTAINING THE PROPERTY COVERED SHALL FIRST SUSTAIN AN ACTUAL DAMAGE TO THE EXTERIOR OF THE ROOF OR WALLS BY THE FALLING OBJECT.

12. Weight of ice, snow or sleet, but only with respect to property contained in a building AND THEN ONLY IF THE WEIGHT OF ICE, SNOW OR SLEET RESULTS IN PHYSICAL DAMAGE TO SUCH BUILDING.

13. Collapse of buildings or any part thereof, BUT COLLAPSE DOES NOT INCLUDE SETTLING, CRACKING, SHRINKAGE, BULGING OR EXPANSION.

14. Sudden and accidental tearing asunder, cracking, burning or bulging of a steam or hot water heating system or of appliances for heating water, BUT NOT INCLUDING LOSS CAUSED BY OR RESULTING FROM FREEZING.

15. Accidental discharge, leakage or overflow of water or steam from within a plumbing, heating or air conditioning system or from within a domestic appliance BUT EXCLUDING LOSS TO THE APPLIANCE FROM WHICH THE WATER OR STEAM ESCAPES. THIS PERIL DOES NOT INCLUDE LOSS CAUSED BY OR RESULTING FROM FREEZING.

16. Freezing of plumbing, heating and air conditioning systems and domestic appliances.

17. Sudden and accidental injury from electrical currents artificially generated to electrical appliances, devices, fixtures and wiring, EXCEPT TUBES, TRANSISTORS AND SIMILAR ELECTRONIC COMPONENTS.

ADDITIONAL EXCLUSIONS

THIS POLICY DOES NOT INSURE AGAINST LOSS:

Under Coverages A, B and C (and under Coverage D—Additional Living Expense resulting from such loss):

1. CAUSED BY, RESULTING FROM, CONTRIBUTED TO OR AGGRAVATED BY ANY OF THE FOLLOWING:

- a. FLOOD, SURFACE WATER, WAVES, TIDAL WATER OR TIDAL WAVE, OVERFLOW OF STREAMS OR OTHER BODIES OF WATER, OR SPRAY FROM ANY OF THE FOREGOING, ALL WHETHER DRIVEN BY WIND OR NOT;
- b. WATER WHICH BACKS UP THROUGH SEWERS OR DRAINS; OR
- c. WATER BELOW THE SURFACE OF THE GROUND INCLUDING THAT WHICH EXERTS PRESSURE ON OR FLOWS, SEEPS OR LEAKS THROUGH SIDEWALKS, DRIVEWAYS, FOUNDATIONS, WALLS, BASEMENT OR OTHER FLOORS OR THROUGH DOORS, WINDOWS OR ANY OTHER OPENINGS IN SUCH SIDEWALKS, DRIVEWAYS, FOUNDATIONS, WALLS, OR FLOORS; (UNLESS LOSS BY FIRE OR EXPLOSION ENSUES, AND THIS COMPANY SHALL THEN BE LIABLE ONLY FOR SUCH ENSUING LOSS, BUT THESE EXCLUSIONS DO NOT APPLY TO LOSS BY THEFT;

2. CAUSED BY, RESULTING FROM, CONTRIBUTED TO OR AGGRAVATED BY ANY EARTH MOVEMENT, INCLUDING BUT NOT LIMITED TO EARTHQUAKE, VOLCANIC ERUPTION, LANDSLIDE, MUDFLOW, EARTH SINKING, RISING OR SHIFTING; UNLESS LOSS BY FIRE, EXPLOSION OR BREAKAGE OF GLASS CONSTITUTING A PART OF THE BUILDING(S) COVERED HEREUNDER, INCLUDING GLASS IN STORM DOORS AND STORM WINDOWS, ENSUES, AND THIS COMPANY SHALL THEN BE LIABLE ONLY FOR SUCH ENSUING LOSS, BUT THIS EXCLUSION DOES NOT APPLY TO LOSS BY THEFT;

3. TO PLUMBING, HEATING OR AIR CONDITIONING SYSTEMS OR DOMESTIC APPLIANCES, OR BY DISCHARGE, LEAKAGE OR OVERFLOW FROM SUCH SYSTEMS OR APPLIANCES, CAUSED BY OR RESULTING FROM FREEZING WHILE THE BUILDING COVERED IS VACANT OR UNOCCUPIED UNLESS THE INSURED SHALL HAVE EXERCISED DUE DILIGENCE WITH RESPECT TO MAINTAINING HEAT IN THE BUILDING OR UNLESS SUCH SYSTEMS AND APPLIANCES HAD BEEN DRAINED AND THE WATER SUPPLY SHUT OFF DURING SUCH VACANCY OR UNOCCUPANCY;

4. OCCASIONED DIRECTLY OR INDIRECTLY BY ENFORCEMENT OF ANY LOCAL OR STATE ORDINANCE OR LAW REGULATING THE CONSTRUCTION, REPAIR, OR DEMOLITION OF BUILDING(S) OR STRUCTURE(S) UNLESS SUCH LIABILITY IS OTHERWISE SPECIFICALLY ASSUMED BY ENDORSEMENT HEREON;

5. TO FENCES, PAVEMENTS, PATIOS, SWIMMING POOLS, FOUNDATIONS, RETAINING WALLS, BULKHEADS, PIERS, WHARVES OR DOCKS WHEN SUCH LOSS IS CAUSED BY FREEZING, THAWING OR BY THE PRESSURE OR WEIGHT OF ICE OR WATER WHETHER DRIVEN BY WIND OR NOT;

6. CAUSED BY OR RESULTING FROM POWER, HEATING OR COOLING FAILURE, UNLESS SUCH FAILURE RESULTS FROM PHYSICAL DAMAGE TO POWER, HEATING OR COOLING EQUIPMENT SITUATED ON THE PREMISES, CAUSED BY A PERIL NOT OTHERWISE EXCLUDED.

Under Coverages A and B (and under Coverage D—Additional Living Expense resulting from such loss):

1. BY WEAR AND TEAR; MARRING OR SCRATCHING; DETERIORATION; INHERENT VICE; LATENT DEFECT; MECHANICAL BREAKDOWN; RUST; MOLD; WET OR DRY ROT; CONTAMINATION; SMOG; SMOKE FROM AGRICULTURAL SMUDGING OR INDUSTRIAL OPERATIONS; SETTling, CRACKING, SHRINKAGE, BULGING OR EXPANSION OF PAVEMENTS, PATIOS, FOUNDATIONS, WALLS, FLOORS, ROOFS OR CEILINGS; BIRDS, VERMIN, RODENTS, INSECTS OR DOMESTIC ANIMALS; UNLESS LOSS BY FIRE SMOKE (OTHER THAN SMOKE FROM AGRICULTURAL SMUDGING OR INDUSTRIAL OPERATIONS), EXPLOSION, COLLAPSE OF A BUILDING, GLASS BREAKAGE OR WATER NOT OTHERWISE EXCLUDED, ENSUES, THEN THIS POLICY SHALL COVER ONLY SUCH ENSUING LOSS. IF LOSS BY WATER NOT OTHERWISE EXCLUDED ENSUES, THIS POLICY SHALL ALSO COVER THE COST OF TEARING OUT AND REPLACING OF ANY PART OF THE BUILDING COVERED REQUIRED TO EFFECT REPAIRS TO THE PLUMBING, HEATING OR AIR CONDITIONING SYSTEM OR DOMESTIC APPLIANCE BUT EXCLUDING LOSS TO THE SYSTEM OR APPLIANCE FROM WHICH THE WATER ESCAPES;

2. BY THEFT IN OR TO A DWELLING UNDER CONSTRUCTION OR OF MATERIALS OR SUPPLIES THEREFOR UNTIL COMPLETED AND OCCUPIED;

3. BY VANDALISM AND MALICIOUS MISCHIEF OR GLASS BREAKAGE, IF THE PROPERTY COVERED HEREUNDER HAD BEEN VACANT BEYOND A PERIOD OF 30 CONSECUTIVE DAYS IMMEDIATELY PRECEDING THE LOSS.

4. BY WIND, HAIL, ICE, SNOW OR SLEET TO OUTDOOR RADIO AND TELEVISION ANTENNAS INCLUDING THEIR LEAD-IN WIRING, MASTS OR TOWERS;

5. LOSS CAUSED BY CONTINUOUS OR REPEATED SEEPAGE OR LEAKAGE OF WATER OR STEAM FROM WITHIN A PLUMBING, HEATING OR AIR CONDITIONING SYSTEM OR FROM WITHIN A DOMESTIC APPLIANCE WHICH OCCURS OVER A PERIOD OF WEEKS, MONTHS OR YEARS.

ADDITIONAL CONDITIONS

1. Replacement Cost — Coverages A and B:

THIS CONDITION SHALL BE APPLICABLE ONLY TO A BUILDING STRUCTURE COVERED HEREUNDER EXCLUDING OUTDOOR RADIO AND TELEVISION ANTENNAS AND AERIALS, CARPETING, AWNINGS, DOMESTIC APPLIANCES AND OUTDOOR EQUIPMENT, ALL WHETHER ATTACHED TO THE BUILDING STRUCTURE OR NOT.

a. IF AT THE TIME OF LOSS THE WHOLE AMOUNT OF INSURANCE APPLICABLE TO SAID BUILDING STRUCTURE FOR THE PERIL CAUSING THE LOSS IS 80% OR MORE OF THE FULL REPLACEMENT COST OF SUCH BUILDING STRUCTURE, THE COVERAGE OF THIS POLICY APPLICABLE TO SUCH BUILDING STRUCTURE IS EXTENDED TO INCLUDE THE FULL COST OF REPAIR OR REPLACEMENT (WITHOUT DEDUCTION FOR DEPRECIATION).

b. IF AT THE TIME OF LOSS THE WHOLE AMOUNT OF INSURANCE APPLICABLE TO SAID BUILDING STRUCTURE FOR THE PERIL CAUSING THE LOSS IS LESS THAN 80% OF THE FULL REPLACEMENT COST OF SUCH BUILDING STRUCTURE, THIS COMPANY'S LIABILITY FOR LOSS UNDER THIS POLICY SHALL NOT EXCEED THE LARGER OF THE FOLLOWING AMOUNTS (1) OR (2):

- (1) THE ACTUAL CASH VALUE OF THAT PART OF THE BUILDING STRUCTURE DAMAGED OR DESTROYED; OR
- (2) THAT PROPORTION OF THE FULL COST OF REPAIR OR REPLACEMENT WITHOUT DEDUCTION FOR DEPRECIATION OF THAT PART OF THE BUILDING STRUCTURE DAMAGED OR DESTROYED, WHICH THE WHOLE AMOUNT OF INSURANCE APPLICABLE TO SAID BUILDING STRUCTURE FOR THE PERIL CAUSING THE LOSS BEARS TO 80% OF THE FULL REPLACEMENT COST OF SUCH BUILDING STRUCTURE.

c. THIS COMPANY'S LIABILITY FOR LOSS UNDER THIS POLICY SHALL NOT EXCEED THE SMALLEST OF THE FOLLOWING AMOUNTS (1), (2), OR (3):

- (1) THE LIMIT OF LIABILITY OF THIS POLICY APPLICABLE TO THE DAMAGED OR DESTROYED BUILDING STRUCTURE;
- (2) THE REPLACEMENT COST OF THE BUILDING STRUCTURE OR ANY PART THEREOF IDENTICAL WITH SUCH BUILDING STRUCTURE ON

THE SAME PREMISES AND INTENDED FOR THE SAME OCCUPANCY AND USE; OR

(3) THE AMOUNT ACTUALLY AND NECESSARILY EXPENDED IN REPAIRING OR REPLACING SAID BUILDING STRUCTURE OR ANY PART THEREOF INTENDED FOR THE SAME OCCUPANCY AND USE.

d. WHEN THE FULL COST OF REPAIR OR REPLACEMENT IS MORE THAN \$1,000 OR MORE THAN 5% OF THE WHOLE AMOUNT OF INSURANCE APPLICABLE TO SAID BUILDING STRUCTURE FOR THE PERIL CAUSING THE LOSS, THIS COMPANY SHALL NOT BE LIABLE FOR ANY LOSS UNDER PARAGRAPH a. OR SUB-PARAGRAPH (2) OF PARAGRAPH b. OF THIS CONDITION UNLESS AND UNTIL ACTUAL REPAIR OR REPLACEMENT IS COMPLETED.

e. IN DETERMINING IF THE WHOLE AMOUNT OF INSURANCE APPLICABLE TO SAID BUILDING STRUCTURE IS 80% OR MORE OF THE FULL REPLACEMENT COST OF SUCH BUILDING STRUCTURE, THE COST OF EXCAVATIONS, UNDERGROUND FLUES AND PIPES, UNDERGROUND WIRING AND DRAINS, AND BRICK, STONE AND CONCRETE FOUNDATIONS, PIERS AND OTHER SUPPORTS WHICH ARE BELOW THE UNDER SURFACE OF THE LOWEST BASEMENT FLOOR, OR WHERE THERE IS NO BASEMENT, WHICH ARE BELOW THE SURFACE OF THE GROUND INSIDE THE FOUNDATION WALLS, SHALL BE DISREGARDED.

f. THE NAMED INSURED MAY ELECT TO DISREGARD THIS CONDITION IN MAKING CLAIM HEREUNDER, BUT SUCH ELECTION SHALL NOT PREJUDICE THE NAMED INSURED'S RIGHT TO MAKE FURTHER CLAIM WITHIN 180 DAYS AFTER LOSS FOR ANY ADDITIONAL LIABILITY BROUGHT ABOUT BY THIS POLICY CONDITION.

2. Special Limits of Liability on Certain Property:

a. This Company shall be liable for loss to trees, shrubs, plants and lawns (EXCEPT THOSE GROWN FOR BUSINESS PURPOSES) ONLY WHEN THE LOSS IS CAUSED BY FIRE, LIGHTNING, EXPLOSION, RIOT, CIVIL COMMOTION, VANDALISM, MALICIOUS MISCHIEF, THEFT, AIRCRAFT, OR VEHICLES NOT OWNED OR OPERATED BY AN OCCUPANT OF THE PREMISES. THIS COMPANY'S LIABILITY FOR LOSS IN ANY ONE OCCURRENCE UNDER THIS PROVISION SHALL NOT EXCEED IN THE AGGREGATE FOR

ALL SUCH PROPERTY 5% OF THE LIMIT OF LIABILITY OF COVERAGE A, NOR MORE THAN \$250 ON ANY ONE TREE, SHRUB OR PLANT, INCLUDING EXPENSE INCURRED FOR REMOVING DEBRIS THEREOF.

b. UNDER COVERAGE C, THIS COMPANY SHALL NOT BE LIABLE FOR LOSS IN ANY ONE OCCURRENCE WITH RESPECT TO THE FOLLOWING PROPERTY FOR MORE THAN:

- (1) \$100 IN THE AGGREGATE ON MONEY, BULLION, NUMISMATIC PROPERTY AND BANK NOTES;
- (2) \$500 IN THE AGGREGATE ON SECURITIES, ACCOUNTS, BILLS, DEEDS, EVIDENCES OF DEBT, LETTERS OF CREDIT, NOTES OTHER THAN BANK NOTES, PASSPORTS, RAILROAD AND OTHER TICKETS OR STAMPS, INCLUDING PHILATELIC PROPERTY;
- (3) \$1,000 ON MANUSCRIPTS;
- (4) \$500 IN THE AGGREGATE FOR LOSS BY THEFT OF JEWELRY, WATCHES, NECKLACES, BRACELETS, GEMS, PRECIOUS AND SEMI-PRECIOUS STONES, GOLD, PLATINUM AND FURS INCLUDING ARTICLES CONTAINING FUR WHICH REPRESENTS ITS PRINCIPAL VALUE;
- (5) \$500 IN THE AGGREGATE ON WATERCRAFT, INCLUDING THEIR TRAILERS (WHETHER LICENSED OR NOT), FURNISHINGS, EQUIPMENT AND OUTBOARD MOTORS; OR
- (6) \$500 ON TRAILERS, NOT OTHERWISE PROVIDED FOR, WHETHER LICENSED OR NOT.

3. Loss Clause:

Loss hereunder shall not reduce the applicable limit of liability under this policy.

4. Mortgage Clause — Coverages A and B only: (This entire clause is void unless name of mortgagee [or trustee] is inserted in the Declarations).

Loss, if any, under this policy, shall be payable to the mortgagee (or trustee), named on the first page of this policy, as interest may appear, under all present or future mortgages upon the property herein described in which the aforesaid may have an interest as mortgagee (or trustee), in order of precedence of said mortgages, and this insurance as to the interest of the mortgagee (or trustee) only therein, shall not be invalidated by any act or neglect of the mortgagor or owner of the within described property, nor by any foreclosure or other proceedings or notice

of sale relating to the property, nor by any change in the title or ownership of the property, nor by the occupation of the premises for purposes more hazardous than are permitted by this policy; provided, that in case the mortgagor or owner shall neglect to pay any premium due under this policy, the mortgagee (or trustee) shall, on demand, pay the same.

Provided also, that the mortgagee (or trustee) shall notify this Company of any change of ownership or occupancy or increase of hazard which shall come to the knowledge of said mortgagee (or trustee) and, unless permitted by this policy, it shall be noted thereon and the mortgagee (or trustee) shall, on demand, pay the premium for such increased hazard for the term of the use thereof, otherwise this policy shall be null and void.

This Company reserves the right to cancel this policy at any time as provided by its terms but in such case this policy shall continue in force for the benefit only of the mortgagee (or trustee) for ten days after notice to the mortgagee (or trustee) of such cancellation and shall then cease, and this Company shall have the right, on like notice to cancel this agreement.

Whenever this Company shall pay the mortgagee (or trustee) any sum for loss under this policy, and shall claim that, as to the mortgagor or owner, no liability therefor existed, this Company shall, to the extent of such payment, be thereupon legally subrogated to all the rights of the party to whom such payment shall be made, under all securities held as collateral to the mortgage debt; or may at its option pay to the mortgagee (or trustee) the whole principal due or to grow due on the mortgage, with interest accrued and shall thereupon receive a full assignment and transfer of the mortgage and of all such other securities; but no subrogation shall impair the right of the mortgagee (or trustee) to recover the full amount of said mortgagee's (or trustee's) claim.

5. Occupancy Clause: IT IS A CONDITION OF THIS POLICY THAT IF THE DESCRIBED DWELLING IS ASSOCIATED WITH AND IN PROXIMITY TO FARMING OPERATIONS (1) THE AGRICULTURAL PRODUCTS PRODUCED ON THE LAND ARE INCIDENTAL TO THE OCCUPANCY OF THE DWELLING AND ARE PRINCIPALLY FOR HOME CONSUMPTION, OR (2) THAT THE OCCUPANTS OF THE DWELLING AND BUILDINGS APPURTENANT THERETO ARE NOT ENGAGED IN THE OPERATION OF THE FARM AND SAID BUILDINGS ARE IN ADDITION TO A COMPLETE SET OF FARM BUILDINGS ON THE FARM AND ARE NOT EXPOSED WITHIN 200 FEET BY ANY FARM BUILDING.



**HOMEOWNERS POLICY — COMPREHENSIVE PERSONAL LIABILITY
CONDITIONS APPLICABLE TO SECTION II**

HO-SECTION II
(Ed. 9-70)
California

COVERAGES

COVERAGE E — PERSONAL LIABILITY

This Company agrees to pay on behalf of the Insured all sums which the insured shall become legally obligated to pay as damages because of bodily injury or property damage, to which this insurance applies, caused by an occurrence. This Company shall have the right and duty, at its own expense, to defend any suit against the Insured seeking damages on account of such bodily injury or property damage, even if any of the allegations of the suit are groundless, false or fraudulent, but may make such investigation and settlement of any claim or suit as it deems expedient. This Company shall not be obligated to pay any claim or judgment or to defend any suit after the applicable limit of this Company's liability has been exhausted by payment of judgments or settlements.

This policy does not apply:

1. Under Coverage E — Personal Liability and Coverage F — Medical Payments to Others:

- a. to bodily injury or property damage arising out of the ownership, maintenance, operation, use, loading or unloading of:
 - (1) any aircraft; or
 - (2) any motor vehicle owned or operated by, or rented or loaned to any Insured; but this subdivision (2) does not apply to bodily injury or property damage occurring on the residence premises if the motor vehicle is not subject to motor vehicle registration because it is used exclusively on the residence premises or kept in dead storage on the residence premises; or
 - (3) any recreational motor vehicle owned by any Insured, if the bodily injury or property damage occurs away from the residence premises; but this subdivision (3) does not apply to golf carts while used for golfing purposes.

This exclusion does not apply to bodily injury to any residence employee arising out of and in the course of his employment by any Insured except while such employee is engaged in the operation or maintenance of aircraft;

- b. to bodily injury or property damage arising out of the ownership, maintenance, operation, use, loading or unloading of any watercraft:
 - (1) owned by or rented to any Insured if the watercraft has inboard or inboard-outboard motor power of more than 50 horsepower or is a sailing vessel (with or without auxiliary power) 26 feet or more in overall length; or
 - (2) powered by any outboard motor(s), singly or in combination of more than 25 total horsepower, if such outboard motor(s) is owned by any Insured at the inception of this policy and not endorsed hereon, unless the Insured reports in writing to this Company within 45 days after acquisition his intention to insure the outboard motor or combination of outboard motors, ownership of which was acquired prior to the policy term.

This exclusion does not apply to (a) bodily injury or property damage occurring on the residence premises or (b) bodily injury to any residence employee arising out of and in the course of his employment by any Insured;

- c. to bodily injury or property damage arising out of the rendering of or failing to render professional services;
- d. to bodily injury or property damage arising out of business pursuits of any Insured except activities therein which are ordinarily incident to non-business pursuits;

COVERAGE F — MEDICAL PAYMENTS TO OTHERS

This Company agrees to pay all reasonable medical expenses, incurred within one year from the date of the accident, to or for each person who sustains bodily injury to which this insurance applies caused by an accident, while such person is:

- 1. on an insured premises with the permission of any Insured; or
- 2. elsewhere, if such bodily injury
 - a. arises out of a condition in the insured premises or the ways immediately adjoining;
 - b. is caused by the activities of any Insured, or by a residence employee in the course of his employment by any Insured;
 - c. is caused by an animal owned by or in the care of any Insured; or
 - d. is sustained by any residence employee and arises out of and in the course of his employment by any Insured.

EXCLUSIONS

- e. to bodily injury or property damage arising out of any premises, other than an insured premises, owned, rented or controlled by any Insured; but this exclusion does not apply to bodily injury to any residence employee arising out of and in the course of his employment by any Insured;
- f. to bodily injury or property damage which is either expected or intended from the standpoint of the Insured.

2. Under Coverage E — Personal Liability

- a. to liability assumed by the Insured under any contract or agreement not in writing or under any contract or agreement in connection with the Insured's business;
- b. to bodily injury to any person, including a residence employee, if the Insured has a policy providing workmen's compensation or occupational disease benefits for such bodily injury or if benefits for such bodily injury are in whole or in part either payable or required to be provided by the Insured under any workmen's compensation or occupational disease law;
- c. to property damage to property owned by the Insured;
- d. to property damage to property occupied or used by the Insured or rented to or in the care, custody or control of the Insured or as to which the Insured is for any purpose exercising physical control;
- e. to sickness, disease or death resulting therefrom of any residence employee unless written claim is made or suit is brought therefor against the Insured within 36 months after the end of the policy term.

3. Under Coverage F — Medical Payments to Others

- a. to bodily injury to any person, including a residence employee, if any person or organization has a policy providing workmen's compensation or occupational disease benefits for such bodily injury or if benefits for such bodily injury are in whole or in part either payable or required to be provided under any workmen's compensation or occupational disease law;
- b. to bodily injury to
 - (1) any Insured under parts (1) and (2) of the definition of "Insured";
 - (2) any person, other than a residence employee, regularly residing on any part of the insured premises; or
 - (3) any person while on the insured premises because a business is conducted or professional services are rendered thereon.

SUPPLEMENTARY COVERAGES

1. **Damage to Property of Others:** This Company will, at its option, either pay for the actual cash value of property damaged or destroyed during the policy period by any Insured, or repair or replace such property with other property of like quality and kind, but in no event shall this Company's limit of liability exceed \$250 in any one occurrence.

This coverage does not apply to damage to or destruction of property:

- a. caused intentionally by any Insured who has attained the age of 13;
 - b. owned by or rented to any Insured, any tenant of any Insured or any resident of Named Insured's household;
 - c. arising out of (1) any act or omission in connection with premises (other than the insured premises) owned, rented or controlled by any Insured, (2) business pursuits or professional services or (3) the ownership, maintenance, operation, use, loading or unloading of any land motor vehicle, trailer or semi-trailer, farm machinery or equipment, aircraft or watercraft;
 - d. if insurance therefor is provided under Section I of this policy.
2. **Personal Liability Claim Expenses:** This Company will pay:
 - a. all expenses incurred by this Company and all costs taxed against the Insured in any suit defended by this Company;
 - b. all premiums on appeal bonds required in any such suit, premiums on bonds to release attachments in any such suit for an amount not in excess of the applicable limit of liability of this policy, and the cost of bail bonds required of the Insured because of accident or traffic law violation arising out of the use of any vehicle to which this policy applies, not to exceed \$250 per bail bond, but this Company shall have no obligation to apply for or furnish any such bonds;
 - c. all interest on the entire amount of any judgment which accrues

after entry of the judgment and before this Company has paid or tendered or deposited in court that part of the judgment which does not exceed the limit of this Company's liability thereon;

- d. reasonable expenses incurred by the Insured at this Company's request, including actual loss of earnings (but not loss of other income) not to exceed \$25 per day because of his attendance at hearings or trials at such request.

Any expenses incurred by this Company under this provision shall not reduce the applicable limit of liability.

3. **First Aid Expenses:** In addition to this Company's limit of liability, this Company will pay expenses incurred by the Insured for first aid to others at the time of an accident, for bodily injury to which this insurance applies.

4. **Property in Control of the Insured:** Such insurance as is afforded under Coverage E — Personal Liability, applies to property damage to any insured premises and to house furnishings therein if such property damage arises out of fire, explosion, or smoke or smudge caused by sudden, unusual and faulty operation of any heating or cooking unit. Exclusion 2.d. does not apply to this Supplementary Coverage.

5. **Construction of New Residence:** Such insurance as is afforded under Coverage E — Personal Liability, applies to bodily injury and property damage arising out of any vacant land owned by or rented to any Insured on which a one or two family dwelling is being constructed for use by any Insured as a residence. Such insurance as is afforded under Coverage F — Medical Payments to Others, applies to bodily injury sustained by any person while on such vacant land with the permission of any Insured. This coverage does not apply to bodily injury to any employee, other than a residence employee, of any Insured arising out of and in the course of his employment by any Insured. Exclusion 1.e. does not apply to this Supplementary Coverage.

ADDITIONAL DEFINITIONS

The following definitions apply only to coverage afforded under Section II of this policy.

1. **"bodily injury":** means bodily injury, sickness or disease, including care, loss of services and death resulting therefrom.
2. **"medical expenses":** means expenses for necessary medical, surgical, x-ray, dental services, including prosthetic devices, ambulance, hospital, professional nursing and funeral services.
3. **"motor vehicle":** means a land motor vehicle, trailer or semi-trailer designed for travel on public roads (including any machinery or apparatus attached thereto) but does not include, except while being towed by or carried on a motor vehicle, any of the following: utility, boat, camp or home trailer, recreational motor vehicle, crawler or farm type tractor, farm implement or, if not subject to motor vehicle registration, any equipment which is designed for use principally off public roads.

4. **"property damage":** means injury to or destruction of tangible property, including loss of use thereof.

5. **"occurrence":** means an accident, including injurious exposure to conditions, which results, during the policy term, in bodily injury or property damage.

6. **"recreational motor vehicle":** means (1) a golf cart or snowmobile or (2) if not subject to motor vehicle registration, any other land motor vehicle designed for recreational use off public roads.

7. **"residence employee":** means an employee of any Insured whose duties are in connection with the maintenance or use of the insured premises, including the performance of household or domestic services, or who performs elsewhere duties of a similar nature not in connection with any Insured's business.

Sections I and II are otherwise subject to the conditions set forth in this policy to which this form is attached.



HOMEOWNERS POLICY — CONTENTS BROAD FORM
This form is void unless HO-Section II is attached
SECTION I

HO-4
(Ed. 8-71)
California

DESCRIPTION OF PROPERTY AND INTERESTS COVERED

COVERAGE C — UNSCHEDULED PERSONAL PROPERTY

This policy covers unscheduled personal property usual or incidental to the occupancy of the premises as a dwelling and owned or used by an Insured, while on the described premises and, at the option of the Named Insured, owned by others while on the portion of the premises occupied exclusively by the Insured.

This coverage also includes such unscheduled personal property while elsewhere than on the described premises anywhere in the world:

1. owned or used by an Insured; or
2. at the option of the Named Insured,
 - a. owned by a guest while in a residence occupied by an Insured; or
 - b. owned by a residence employee while actually engaged in the service of an Insured and while such property is in the physical custody of such residence employee or in a residence occupied by an Insured;
3. but the limit of this Company's liability for the unscheduled personal property away from the premises shall be an additional amount of insurance equal to 10% of the amount specified for Coverage C, but in no event less than \$1,000.

THIS COVERAGE EXCLUDES:

1. ANIMALS, BIRDS OR FISH;
2. MOTORIZED VEHICLES, EXCEPT SUCH VEHICLES PERTAINING TO THE SERVICE OF THE PREMISES AND NOT LICENSED FOR ROAD USE;
3. AIRCRAFT;
4. PROPERTY OF ROOMERS AND BOARDERS NOT RELATED TO THE INSURED;
5. PROPERTY CARRIED OR HELD AS SAMPLES OR FOR SALE OR FOR DELIVERY AFTER SALE;
6. PROPERTY RENTED OR HELD FOR RENTAL TO OTHERS BY THE INSURED, EXCEPT PROPERTY CONTAINED IN THAT PORTION OF THE DESCRIBED PREMISES CUSTOMARILY OCCUPIED EXCLUSIVELY BY THE

INSURED AND OCCASIONALLY RENTED TO OTHERS OR PROPERTY OF THE INSURED IN THAT PORTION OF THE DESCRIBED DWELLING OCCUPIED BY ROOMERS OR BOARDERS;

7. BUSINESS PROPERTY WHILE AWAY FROM THE DESCRIBED PREMISES;

8. ANY DEVICE OR INSTRUMENT FOR THE RECORDING, REPRODUCTION OR RECORDING AND REPRODUCTION OF SOUND WHICH MAY BE OPERATED BY POWER FROM THE ELECTRICAL SYSTEMS OF A MOTOR VEHICLE, OR ANY TAPE, WIRE, RECORD DISC OR OTHER MEDIUM FOR USE WITH ANY SUCH DEVICE OR INSTRUMENT WHILE ANY OF SAID PROPERTY IS IN OR UPON A MOTOR VEHICLE; OR

9. PROPERTY WHICH IS SEPARATELY DESCRIBED AND SPECIFICALLY INSURED IN WHOLE OR IN PART BY THIS OR ANY OTHER INSURANCE.

COVERAGE D — ADDITIONAL LIVING EXPENSE

If loss or damage by a peril insured against under this policy to property covered hereunder or to the building containing such property renders the premises untenable, this policy covers the necessary increase in living expense incurred by the Named Insured to continue as nearly as practicable the normal standard of living of the Named Insured's household FOR NOT EXCEEDING THE PERIOD OF TIME REQUIRED:

1. TO REPAIR OR REPLACE SUCH DAMAGED OR DESTROYED PROPERTY AS SOON AS POSSIBLE; OR
2. FOR THE NAMED INSURED'S HOUSEHOLD TO BECOME SETTLED IN PERMANENT QUARTERS; WHICHEVER IS LESS.

This coverage also includes the period of time, NOT EXCEEDING TWO WEEKS, while access to the premises is prohibited by order of civil authority, as a direct result of damage to neighboring premises by a peril insured against.

The period described above shall not be limited by the expiration of this policy.

THIS COVERAGE EXCLUDES EXPENSE DUE TO CANCELLATION OF ANY LEASE, OR ANY WRITTEN OR ORAL AGREEMENT.

SUPPLEMENTARY COVERAGES

The following supplementary coverages SHALL NOT INCREASE THE APPLICABLE LIMIT OF LIABILITY UNDER THIS POLICY:

1. **Automatic Removal:** If, during the term of this policy, the Named Insured removes unscheduled personal property covered under Coverage C from the premises to another location within the Continental United States or the State of Hawaii, to be occupied as his principal residence, the limit of liability for Coverage C shall apply at each location in the proportion that the value at each location bears to the total value of all such property covered under Coverage C.

PROPERTY IN TRANSIT SHALL BE SUBJECT TO THE LIMIT OF LIABILITY FOR UNSCHEDULED PERSONAL PROPERTY AWAY FROM THE PREMISES.

This coverage shall apply ONLY FOR A PERIOD OF 30 DAYS from the date removal commences and shall then cease.

2. **Building Additions and Alterations — APPLICABLE ONLY IF THE INSURED IS NOT THE OWNER OF THE PREMISES.** This policy covers under Coverage C, building additions and alterations, defined as fixtures, alterations, installations or additions comprising a part of the described building, only when situated within that portion of the premises used exclusively by the Named Insured, and made or acquired at the expense

of the Named Insured FOR AN AMOUNT NOT EXCEEDING 10% OF THE LIMIT OF LIABILITY APPLICABLE TO COVERAGE C.

3. **Debris Removal:** This policy covers expenses incurred in the removal of all debris of the property covered hereunder, occasioned by loss thereto for which coverage is afforded.

4. **Fire Department Service Charge:** This policy covers for an amount NOT EXCEEDING \$250 the Named Insured's liability, assumed by contract or agreement for fire department charges where fire department is called because of a fire in, on or exposing property insured hereunder, while located on the premises described. THIS COVERAGE DOES NOT COVER THE NAMED INSURED'S LIABILITY, BY CONTRACT OR OTHERWISE, TO INDEMNIFY EITHER A CITY, MUNICIPALITY OR FIRE PROTECTION DISTRICT, OR ANY OTHER PERSON, FIRM OR CORPORATION AGAINST LOSS, CLAIM OR LIABILITY ARISING BY REASONS OF THE MOVEMENT OR FUNCTIONING OF FIRE APPARATUS OR MEMBERS OF A FIRE DEPARTMENT; OR BY REASON OF ANY ACCIDENT ARISING OUT OF THE PERFORMANCE OF SERVICES BY ANY FIRE DEPARTMENT. COVERAGE AFFORDED UNDER THIS CLAUSE APPLIES ONLY IF THE PROPERTY IS NOT LOCATED WITHIN THE LIMITS OF THE CITY, MUNICIPALITY OR FIRE PROTECTION DISTRICT FURNISHING SUCH FIRE DEPARTMENT RESPONSE.

DEDUCTIBLE

Loss Deductible Clause: WITH RESPECT TO LOSS COVERED UNDER THIS POLICY, THIS COMPANY SHALL BE LIABLE ONLY WHEN SUCH LOSS IN EACH OCCURRENCE EXCEEDS \$100 AND THEN ONLY FOR THE AMOUNT OF

SUCH EXCESS.

THIS LOSS DEDUCTIBLE CLAUSE SHALL NOT APPLY TO COVERAGE D — ADDITIONAL LIVING EXPENSE OR FIRE DEPARTMENT SERVICE CHARGE.

PERILS INSURED AGAINST

This policy insures against direct loss to the property covered by the following perils AS DEFINED AND LIMITED HEREIN:

1. **Fire or Lightning.**

2. **Removal,** meaning direct loss by removal of the property covered hereunder from premises endangered by the perils insured against.

The applicable limit of liability, had the property not been removed, applies pro rata for 30 days at each proper place to which any of the property shall necessarily be removed for preservation from or for repair of damages caused by the perils insured against.

3. **Windstorm or Hail, EXCLUDING LOSS.**

a. CAUSED DIRECTLY OR INDIRECTLY BY FROST OR COLD WEATHER OR ICE (OTHER THAN HAIL), SNOW OR SLEET, ALL WHETHER DRIVEN BY WIND OR NOT;

b. CAUSED BY RAIN, SNOW, SAND OR DUST, ALL WHETHER DRIVEN BY WIND OR NOT, UNLESS THE BUILDING CONTAINING THE PROPERTY COVERED SHALL FIRST SUSTAIN AN ACTUAL DAMAGE TO ROOF OR WALLS BY THE DIRECT FORCE OF WIND OR HAIL AND THEN THIS COMPANY SHALL BE LIABLE FOR LOSS TO THE PROPERTY COVERED THEREIN CAUSED BY RAIN, SNOW, SAND OR DUST ENTERING THE BUILDING THROUGH OPENINGS IN THE ROOF OR WALLS MADE BY DIRECT ACTION OF WIND OR HAIL; OR

c. TO WATERCRAFT (EXCEPT ROWBOATS AND CANOES ON PREMISES) INCLUDING THEIR TRAILERS, FURNISHINGS, EQUIPMENT AND OUTBOARD MOTORS WHILE SUCH PROPERTY IS NOT INSIDE FULLY ENCLOSED BUILDINGS.

d. TO OUTDOOR RADIO AND TELEVISION ANTENNAS INCLUDING THEIR LEAD-IN WIRING, MASTS OR TOWERS.

4. Explosion.

5. Riot or Civil Commotion, including direct loss from pillage and looting occurring during and at the immediate place of a riot or civil commotion.

6. Aircraft, including self-propelled missiles or spacecraft.

7. Vehicles.

8. Sudden and accidental damage from smoke, OTHER THAN SMOKE FROM AGRICULTURAL SMUDGING OR INDUSTRIAL OPERATIONS.

9. Vandalism or Malicious Mischief, MEANING ONLY THE WILFUL AND MALICIOUS DAMAGE TO OR DESTRUCTION OF THE PROPERTY COVERED.

10. Theft, meaning any act of stealing or attempt thereof, including loss of property from a known place under circumstances when a probability of theft exists.

Unscheduled personal property contained in any bank, trust or safe deposit company, public warehouse or occupied dwelling not owned or occupied by or rented to an Insured in which the property covered has been placed for safekeeping shall be considered as being on the described premises.

UPON KNOWLEDGE OF LOSS UNDER THIS PERIL OR OF AN OCCURRENCE WHICH MAY GIVE RISE TO A CLAIM FOR SUCH LOSS, THE INSURED SHALL GIVE IMMEDIATE NOTICE TO THIS COMPANY OR ITS AUTHORIZED AGENTS AND ALSO TO THE POLICE.

a. GENERAL THEFT EXCLUSIONS:

THIS POLICY DOES NOT APPLY TO LOSS:

(1) IF COMMITTED BY AN INSURED;

(2) IN OR TO A DWELLING UNDER CONSTRUCTION OR OF MATERIALS OR SUPPLIES THEREFOR UNTIL COMPLETED AND OCCUPIED;

(3) ARISING OUT OF OR RESULTING FROM THE THEFT OF ANY CREDIT CARD OR LOSS BY FORGERY OR ALTERATIONS OF ANY CHECK, DRAFT, PROMISSORY NOTE, BILL OF EXCHANGE, OR SIMILAR WRITTEN PROMISE, ORDER OR DIRECTION TO PAY A SUM CERTAIN IN MONEY; OR

(4) OF A PRECIOUS OR SEMI-PRECIOUS STONE FROM ITS SETTING.

b. THEFT EXCLUSIONS APPLICABLE WHILE THE DESCRIBED DWELLING IS RENTED TO OTHERS:

THIS POLICY DOES NOT APPLY TO LOSS FROM THE DESCRIBED DWELLING WHILE THE PORTION OF THE DESCRIBED DWELLING CUSTOMARILY OCCUPIED EXCLUSIVELY BY AN INSURED IS RENTED TO OTHERS:

(1) OF MONEY, BULLION, NUMISMATIC PROPERTY OR BANK NOTES;

(2) OF SECURITIES, ACCOUNTS, BILLS, DEEDS, EVIDENCES OF DEBT, LETTERS OF CREDIT, NOTES OTHER THAN BANK NOTES, PASSPORTS, RAILROAD AND OTHER TICKETS OR STAMPS, INCLUDING PHILATELIC PROPERTY;

(3) OF JEWELRY, WATCHES, NECKLACES, BRACELETS, GEMS, PRECIOUS AND SEMI-PRECIOUS STONES; ARTICLES OF GOLD AND PLATINUM; OR ANY ARTICLE OF FUR OR ARTICLE CONTAINING FUR WHICH REPRESENTS ITS PRINCIPAL VALUE; OR

(4) CAUSED BY A TENANT, HIS EMPLOYEES OR MEMBERS OF HIS

HOUSEHOLD WHILE RENTING THE PORTION OF THE DESCRIBED DWELLING CUSTOMARILY OCCUPIED EXCLUSIVELY BY AN INSURED.

c. THEFT EXCLUSIONS APPLICABLE TO PROPERTY AWAY FROM THE DESCRIBED PREMISES:

THIS POLICY DOES NOT APPLY TO LOSS AWAY FROM THE DESCRIBED PREMISES OF:

(1) PROPERTY WHILE IN ANY DWELLING OR PREMISES THEREOF, OWNED, RENTED OR OCCUPIED BY AN INSURED, EXCEPT WHILE AN INSURED IS TEMPORARILY RESIDING THEREIN;

(2) PROPERTY WHILE UNATTENDED IN OR ON ANY MOTOR VEHICLE OR TRAILER OTHER THAN A PUBLIC CONVEYANCE, UNLESS THE LOSS IS THE RESULT OF FORCIBLE ENTRY INTO SUCH VEHICLE WHILE ALL DOORS, WINDOWS OR OTHER OPENINGS THEREOF ARE CLOSED AND LOCKED, PROVIDED THERE ARE VISIBLE MARKS OF FORCIBLE ENTRY UPON THE EXTERIOR OF SUCH VEHICLE OR THE LOSS IS THE RESULT OF THE THEFT OF SUCH VEHICLE WHICH IS NOT RECOVERED WITHIN 30 DAYS, BUT PROPERTY SHALL NOT BE CONSIDERED UNATTENDED WHEN THE INSURED IS REQUIRED TO SURRENDER THE KEYS OF SUCH VEHICLE TO A BAILEE;

(3) PROPERTY WHILE UNATTENDED IN OR ON PRIVATE WATERCRAFT UNLESS THE LOSS IS THE DIRECT RESULT OF FORCIBLE ENTRY INTO A SECURELY LOCKED COMPARTMENT AND PROVIDED THERE ARE VISIBLE MARKS OF FORCIBLE ENTRY UPON THE EXTERIOR OF SUCH COMPARTMENT;

(4) WATERCRAFT, THEIR FURNISHINGS, EQUIPMENT AND OUTBOARD MOTORS; OR

(5) TRAILERS, WHETHER LICENSED OR NOT.

11. Falling objects, BUT EXCLUDING LOSS TO:

a. OUTDOOR RADIO AND TELEVISION ANTENNAS INCLUDING THEIR LEAD-IN WIRING, MASTS OR TOWERS; OR

b. PROPERTY WITHIN A BUILDING, UNLESS THE BUILDING CONTAINING THE PROPERTY COVERED SHALL FIRST SUSTAIN AN ACTUAL DAMAGE TO THE EXTERIOR OF THE ROOF OR WALLS BY THE FALLING OBJECT.

12. Weight of ice, snow or sleet, BUT ONLY WITH RESPECT TO PROPERTY CONTAINED IN A BUILDING AND THEN ONLY IF THE WEIGHT OF ICE, SNOW OR SLEET RESULTS IN PHYSICAL DAMAGE TO SUCH BUILDING, BUT EXCLUDING LOSS TO OUTDOOR RADIO AND TELEVISION ANTENNAS INCLUDING THEIR LEAD-IN WIRING, MASTS OR TOWERS.

13. Collapse of buildings or any part thereof, BUT EXCLUDING LOSS TO OUTDOOR RADIO AND TELEVISION ANTENNAS INCLUDING THEIR LEAD-IN WIRING, MASTS OR TOWERS.

COLLAPSE DOES NOT INCLUDE SETTLING, CRACKING, SHRINKAGE, BULGING OR EXPANSION.

14. Sudden and accidental tearing asunder, cracking, burning or bulging of a steam or hot water heating system or of appliances for heating water, BUT NOT INCLUDING LOSS CAUSED BY OR RESULTING FROM FREEZING.

15. Accidental discharge, leakage or overflow of water or steam from within a plumbing, heating or air conditioning system or from within a domestic appliance BUT EXCLUDING LOSS TO THE SYSTEM OR APPLIANCE FROM WHICH THE WATER OR STEAM ESCAPES. THIS PERIL DOES NOT INCLUDE LOSS CAUSED BY OR RESULTING FROM FREEZING.

16. Freezing of plumbing, heating and air conditioning systems and domestic appliances, BUT EXCLUDING LOSS CAUSED BY OR RESULTING FROM FREEZING WHILE THAT PORTION OF THE BUILDING NORMALLY OCCUPIED BY THE INSURED IS VACANT OR UNOCCUPIED, UNLESS THE INSURED SHALL HAVE EXERCISED DUE DILIGENCE WITH RESPECT TO MAINTAINING HEAT IN THE BUILDING OR UNLESS THE PLUMBING AND HEATING SYSTEMS AND DOMESTIC APPLIANCES HAD BEEN DRAINED AND THE WATER SUPPLY SHUT OFF DURING SUCH VACANCY OR UNOCCUPANCY.

17. Sudden and accidental injury from electrical currents artificially generated to electrical appliances, devices, fixtures and wiring, EXCEPT TUBES, TRANSISTORS AND SIMILAR ELECTRONIC COMPONENTS.

ADDITIONAL EXCLUSIONS

THIS POLICY DOES NOT INSURE AGAINST LOSS:

1. OCCASIONED DIRECTLY OR INDIRECTLY BY ENFORCEMENT OF ANY LOCAL OR STATE ORDINANCE OR LAW REGULATING THE CONSTRUCTION, REPAIR, OR DEMOLITION OF BUILDING(S) OR STRUCTURE(S) UNLESS SUCH LIABILITY IS OTHERWISE SPECIFICALLY ASSUMED BY ENDORSEMENT HEREON;

2. CAUSED BY, RESULTING FROM, CONTRIBUTED TO OR AGGRAVATED BY ANY EARTH MOVEMENT, INCLUDING BUT NOT LIMITED TO EARTHQUAKE, VOLCANIC ERUPTION, LANDSLIDE, MUDFLOW, EARTH SINKING, RISING OR

SHIFTING; UNLESS LOSS BY FIRE OR EXPLOSION ENSUES, AND THIS COMPANY SHALL THEN BE LIABLE ONLY FOR SUCH ENSUING LOSS, BUT THIS EXCLUSION DOES NOT APPLY TO LOSS BY THEFT;

3. CAUSED BY, RESULTING FROM, CONTRIBUTED TO OR AGGRAVATED BY ANY OF THE FOLLOWING:

a. FLOOD, SURFACE WATER, WAVES, TIDAL WATER OR TIDAL WAVE, OVERFLOW OF STREAMS OR OTHER BODIES OF WATER, OR SPRAY FROM ANY OF THE FOREGOING, ALL WHETHER DRIVEN BY WIND OR NOT;

b. WATER WHICH BACKS UP THROUGH SEWERS OR DRAINS; OR

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RAILROAD AND OTHER TICKETS OR STAMPS, INCLUDING PHILATELIC PROPERTY;

(3) OF JEWELRY, WATCHES, NECKLACES, BRACELETS, GEMS, PRECIOUS AND SEMI-PRECIOUS STONES, ARTICLES OF GOLD AND PLATINUM; OR ANY ARTICLE OF FUR OR ARTICLE CONTAINING FUR WHICH REPRESENTS ITS PRINCIPAL VALUE; OR

(4) CAUSED BY A TENANT, HIS EMPLOYEES OR MEMBERS OF HIS

ADDITIONAL EXCLUSIONS

THIS POLICY DOES NOT INSURE AGAINST LOSS:

1. OCCASIONED DIRECTLY OR INDIRECTLY BY ENFORCEMENT OF ANY LOCAL OR STATE ORDINANCE OR LAW REGULATING THE CONSTRUCTION, REPAIR, OR DEMOLITION OF BUILDING(S) OR STRUCTURE(S) UNLESS SUCH LIABILITY IS OTHERWISE SPECIFICALLY ASSUMED BY ENDORSEMENT HEREON;

2. CAUSED BY, RESULTING FROM, CONTRIBUTED TO OR AGGRAVATED BY ANY EARTH MOVEMENT, INCLUDING BUT NOT LIMITED TO EARTHQUAKE, VOLCANIC ERUPTION, LANDSLIDE, MUDFLOW, EARTH SINKING, RISING OR

INSURED SHALL HAVE EXERCISED DUE DILIGENCE WITH RESPECT TO MAINTAINING HEAT IN THE BUILDING OR UNLESS THE PLUMBING AND HEATING SYSTEMS AND DOMESTIC APPLIANCES HAD BEEN DRAINED AND THE WATER SUPPLY SHUT OFF DURING SUCH VACANCY OR UNOCCUPANCY.

17. Sudden and accidental injury from electrical currents artificially generated to electrical appliances, devices, fixtures and wiring, EXCEPT TUBES, TRANSISTORS AND SIMILAR ELECTRONIC COMPONENTS.

SHIFTING; UNLESS LOSS BY FIRE OR EXPLOSION ENSUES, AND THIS COMPANY SHALL THEN BE LIABLE ONLY FOR SUCH ENSUING LOSS, BUT THIS EXCLUSION DOES NOT APPLY TO LOSS BY THEFT;

3. CAUSED BY, RESULTING FROM, CONTRIBUTED TO OR AGGRAVATED BY ANY OF THE FOLLOWING:

a. FLOOD, SURFACE WATER, WAVES, TIDAL WATER OR TIDAL WAVE, OVERFLOW OF STREAMS OR OTHER BODIES OF WATER, OR SPRAY FROM ANY OF THE FOREGOING, ALL WHETHER DRIVEN BY WIND OR NOT;

b. WATER WHICH BACKS UP THROUGH SEWERS OR DRAINS; OR

c. WATER BELOW THE SURFACE OF THE GROUND INCLUDING THAT WHICH EXERTS PRESSURE ON OR FLOWS, SEEPS OR LEAKS THROUGH SIDEWALKS, DRIVEWAYS, FOUNDATIONS, WALLS, BASEMENT OR OTHER FLOORS OR THROUGH DOORS, WINDOWS OR ANY OTHER OPENINGS IN SUCH SIDEWALKS, DRIVEWAYS, FOUNDATIONS, WALLS OR FLOORS; UNLESS LOSS BY FIRE OR EXPLOSION ENSUES, AND THIS COMPANY SHALL

THEN BE LIABLE ONLY FOR SUCH ENSUING LOSS, BUT THESE EXCLUSIONS DO NOT APPLY TO LOSS BY THEFT;

4. CAUSED BY OR RESULTING FROM POWER, HEATING OR COOLING FAILURE, UNLESS SUCH FAILURE RESULTS FROM PHYSICAL DAMAGE TO POWER, HEATING OR COOLING EQUIPMENT SITUATED ON THE PREMISES, CAUSED BY A PERIL INSURED AGAINST.

ADDITIONAL CONDITIONS

1. Special Limits of Liability on Certain Property:

a. This Company shall be liable for loss to trees, shrubs, plants and lawns (EXCEPT THOSE GROWN FOR BUSINESS PURPOSES) ONLY WHEN THE LOSS IS CAUSED BY FIRE, LIGHTNING, EXPLOSION, RIOT, CIVIL COMMOTION, VANDALISM, MALICIOUS MISCHIEF, THEFT, AIRCRAFT, OR VEHICLES NOT OWNED OR OPERATED BY AN OCCUPANT OF THE PREMISES. THIS COMPANY'S LIABILITY FOR LOSS IN ANY ONE OCCURRENCE UNDER THIS PROVISION SHALL NOT EXCEED IN THE AGGREGATE FOR ALL SUCH PROPERTY 10% OF THE LIMIT OF LIABILITY OF COVERAGE C NOR MORE THAN \$250 ON ANY ONE TREE, SHRUB OR PLANT, INCLUDING EXPENSE INCURRED FOR REMOVING DEBRIS THEREOF.

b. UNDER COVERAGE C, THIS COMPANY SHALL NOT BE LIABLE FOR LOSS IN ANY ONE OCCURRENCE WITH RESPECT TO THE FOLLOWING PROPERTY FOR MORE THAN:

(1) \$100 IN THE AGGREGATE ON MONEY, BULLION, NUMISMATIC PROPERTY AND BANK NOTES;

(2) \$500 IN THE AGGREGATE ON SECURITIES, ACCOUNTS, BILLS, DEEDS, EVIDENCES OF DEBT, LETTERS OF CREDIT, NOTES OTHER THAN BANK NOTES, PASSPORTS, RAILROAD AND OTHER TICKETS OR STAMPS, INCLUDING PHILATELIC PROPERTY;

(3) \$1,000 ON MANUSCRIPTS;

(4) \$500 IN THE AGGREGATE FOR LOSS BY THEFT OF JEWELRY,

WATCHES, NECKLACES, BRACELETS, GEMS, PRECIOUS AND SEMI-PRECIOUS STONES, GOLD, PLATINUM AND FURS INCLUDING ARTICLES CONTAINING FUR WHICH REPRESENTS ITS PRINCIPAL VALUE;

(5) \$500 IN THE AGGREGATE ON WATERCRAFT, INCLUDING THEIR TRAILERS (WHETHER LICENSED OR NOT), FURNISHINGS, EQUIPMENT AND OUTBOARD MOTORS; OR

(6) \$500 ON TRAILERS, NOT OTHERWISE PROVIDED FOR, WHETHER LICENSED OR NOT.

2. **Loss Clause:** Loss hereunder shall not reduce the applicable limit of liability under this policy.

3. **Other Insurance:** OTHER INSURANCE ON THE PROPERTY COVERED HEREUNDER (EXCEPT INSURANCE AGAINST PERILS NOT COVERED BY THIS POLICY) IS NOT PERMITTED.

4. **Occupancy Clause:** IT IS A CONDITION OF THIS POLICY THAT IF THE DESCRIBED DWELLING IS ASSOCIATED WITH AND IN PROXIMITY TO FARMING OPERATIONS (1) THE AGRICULTURAL PRODUCTS PRODUCED ON THE LAND ARE INCIDENTAL TO THE OCCUPANCY OF THE DWELLING AND ARE PRINCIPALLY FOR HOME CONSUMPTION, OR (2) THAT THE OCCUPANTS OF THE DWELLING AND BUILDINGS APPURTENANT THERETO ARE NOT ENGAGED IN THE OPERATION OF THE FARM AND SAID BUILDINGS ARE IN ADDITION TO A COMPLETE SET OF FARM BUILDINGS ON THE FARM AND ARE NOT EXPOSED WITHIN 200 FEET BY ANY FARM BUILDING.



SCHEDULED PERSONAL PROPERTY ENDORSEMENT

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(Ed. 1-74)

In consideration of an additional premium, this policy covers Scheduled Personal Property for which an amount of insurance is indicated below or on schedules forming a part hereof. The coverage afforded by this endorsement is subject to the provisions on page 2 of the policy, the "General Conditions", except as provided herein and the "Conditions Applicable only to Section I".

Class of Personal Property	Amount of Insurance	Premium
1. Jewelry, as scheduled.	\$	\$
2. Furs and garments trimmed with fur or consisting principally of fur, as scheduled.		
3. Cameras, projection machines, films and articles of equipment pertaining thereto, as listed.		
4. Musical instruments and articles of equipment pertaining thereto, as listed.		
5. "Silverware," meaning silverware, silver-platedware, goldware, gold-platedware and pewterware.		
6. Golfer's equipment.		
7. Fine Arts, as scheduled. Premium for this insurance has been computed based upon the statement of the Insured that at the time of attachment of this insurance the property insured hereunder was located as follows: At At New Acquisitions: If the Insured acquires during the term of this endorsement other objects of art the provisions of this endorsement shall apply thereto for the actual cash value of said objects not exceeding % of the aggregate amount of the schedule, PROVIDED the Insured reports such additional objects within 90 days from the date acquired and pays pro rata additional premium thereon from the date acquired.		
8. Postage Stamps including due, envelope, official, revenue, match and medicine stamps, covers, locals, reprints, essays, proofs and other philatelic property owned by or in custody or control of the Insured, including the books, pages and/or mountings therefor.		
9. Rare and Current Coins, medals, paper money, bank notes, tokens of money and other numismatic property owned by or in custody or control of the Insured, including coin albums, containers, frames, cards and display cabinets in use with such collection.		

SCHEDULE

Article	Description	Amount of Insurance
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ADDITIONALLY ACQUIRED PROPERTY

The following clause is applicable only to jewelry, watches, furs, cameras and musical instruments when such property is covered hereunder.

In consideration of the agreement by the Insured to report additional property of the kind insured hereunder, acquired by the Insured subsequent to the attachment date of this endorsement, within thirty (30) days from the date acquired and to pay full premium thereon from the date acquired at pro rata of the current rates of this Company for such insurance, this endorsement covers on each separate class of such additionally acquired property for not exceeding 25% or \$10,000 whichever is the lesser, of the amount of insurance on such class exclusive of this provision. It is specifically understood and agreed by the Insured that this endorsement shall cease to cover such additionally acquired property if it is not reported to this Company within the stated thirty (30) day period.

This additional coverage does not apply to property of a class not already covered hereunder.

PERILS INSURED AGAINST

This endorsement insures against all risks of physical loss or damage except as excluded or limited herein.

(OVER)

This endorsement must be attached to Change Endorsement HO-45 when issued after the policy is written.

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TERRITORIAL LIMITS

Unless otherwise provided hereinafter or endorsed hereon this insurance covers wherever the property may be located.

ADDITIONAL EXCLUSIONS

This endorsement does not insure against:

1. loss caused by wear and tear, gradual deterioration, insects, vermin, or inherent vice;
2. loss by nuclear reaction or nuclear radiation or radioactive contamination, all whether controlled or uncontrolled, and whether such loss be direct or indirect, proximate or remote, or be in whole or in part caused by, contributed to, or aggravated by the peril(s) insured against in this endorsement; however, subject to the foregoing and all provisions of this policy, direct loss by fire resulting from nuclear reaction or nuclear radiation or radioactive contamination is insured against by this endorsement.
3. As to Fine Arts:
 - a. damage sustained due to and resulting from any repairing, restoration or retouching process;
 - b. breakage of art glass windows, statuary, marbles, glassware, bric-a-brac, porcelains and similar fragile articles unless caused by fire, lightning, aircraft, theft or attempted theft, cyclone, tornado, windstorm, earthquake, flood, explosion, malicious damage or collision, derailment or overturn of conveyance, unless endorsed hereon;

c. loss to property on exhibition at fair grounds or on the premises of any national or international exposition unless such premises are specifically herein described.

4. As to Postage Stamps or Rare and Current Coin Collections:

a. fading, creasing, denting, scratching, tearing, thinning, transfer of colors, inherent defect, dampness, extremes of temperature, gradual depreciation, or damage sustained from handling or while being actually worked upon and resulting therefrom;

b. mysterious disappearance of individual stamps, coins or other individual articles insured hereunder unless specifically scheduled herein with a definite amount set opposite their description, or if not specifically scheduled, unless mounted in a volume, and the page to which they are attached is also lost;

c. loss of or damage to property in the custody of transportation companies; nor shipments by mail unless by registered mail;

d. theft from any unattended automobile except while being shipped by registered mail;

e. loss of or damage to any property described herein which is not an actual part of a stamp, money or numismatic collection.

SPECIAL CONDITIONS

1. **Fine Arts:** If Fine Arts are covered hereunder, the Insured represents and agrees that the property insured hereunder will be packed and unpacked by competent packers.

This Company shall not be liable for more than the amount set opposite the respective articles covered hereunder, which amounts are agreed to be the value of said articles.

In the event of the total loss of any article or articles which are a part of a set, this Company agrees to pay the Insured the full amount of the value of such set as specified in the schedule attached, and the Insured agrees to surrender the remaining articles or articles of the set to this Company.

This insurance covers the property insured while on exhibition or otherwise within the limits of the Continental United States, the State of Hawaii and Canada except as hereinbefore excluded.

2. **Golfer's Equipment:** If golfer's equipment is covered hereunder, this insurance shall cover golf clubs, golf clothing and golf equipment, which is the property of the Named Insured, but excluding watches, jewelry and stock for sale; also on other clothing of the Named Insured while contained in any locker situated in a club house or other building used in connection with the game of golf; except that golf balls are covered hereunder only against loss by fire or burglary, meaning the felonious abstraction of the balls from within a building, room or locker by any persons making felonious entry therein by actual force or violence, of which there shall be visible marks made upon the exterior of such premises at the place of such entry.

3. **Musical Instruments:** If musical instruments are covered hereunder, the Insured represents and agrees such instruments insured hereunder will not be played for remuneration during the term of this endorsement, unless otherwise endorsed hereon and additional premium paid at the current rates of this Company.

4. **Silverware:** Silverware shall not include: pens, pencils, flasks, smoking implements or accessories or articles of personal adornment.

5. **POSTAGE STAMPS OR RARE AND CURRENT COIN COLLECTION:** IF A STAMP OR A COIN COLLECTION IS COVERED HEREUNDER, IN THE EVENT OF LOSS OR DAMAGE THE AMOUNT PAYABLE HEREUNDER SHALL BE ASCERTAINED IN THE FOLLOWING MANNER:

A. IN CASE OF LOSS OF OR DAMAGE TO PROPERTY SCHEDULED HEREIN AND REPRESENTING ANY ONE STAMP, COIN OR OTHER INDIVIDUAL ARTICLE INSURED, THIS COMPANY SHALL PAY OR MAKE GOOD TO THE INSURED SUCH LOSS OR DAMAGE UP TO BUT NOT EXCEEDING THE AMOUNT(S) SET OPPOSITE THE ITEM(S) INVOLVED.

B. IN CASE OF LOSS OF OR DAMAGE TO PROPERTY SPECIFICALLY DESCRIBED IN THE ABOVE SCHEDULE AS PAIRS, STRIPS, BLOCKS, SERIES, SHEETS, COVERS, FRAMES, CARDS OR THE LIKE, THIS COMPANY SHALL PAY IN THE EVENT OF TOTAL LOSS OF SUCH AN ITEM UP TO BUT NOT EXCEEDING THE AMOUNT SET OPPOSITE THE ITEM INVOLVED AND IN THE EVENT OF PARTIAL LOSS NOT

MORE THAN THE CASH MARKET VALUE OF THE WHOLE SET, LESS THE CASH MARKET VALUE OF THE REMAINDER AT THE TIME OF LOSS, IT BEING HOWEVER UNDERSTOOD AND AGREED THAT IN THE EVENT OF THE PROPERTY BEING INSURED FOR LESS THAN THE CASH MARKET VALUE, THE LIABILITY OF THIS COMPANY SHALL NOT EXCEED THE PROPORTION THAT THE AMOUNT INSURED BEARS TO THE CASH MARKET VALUE:

C. IN ALL CASES OF LOSS OF OR DAMAGE TO THE INSURED PROPERTY NOT PROVIDED FOR IN THE TWO PREVIOUS PARAGRAPHS, THIS COMPANY SHALL NOT BE LIABLE FOR MORE THAN THE ACTUAL CASH MARKET VALUE OF THE PROPERTY AT THE TIME OF LOSS, SUBJECT HOWEVER TO A LIMIT OF NOT EXCEEDING \$1,000 ON UNSCHEDULED NUMISMATIC PROPERTY AND NOT EXCEEDING \$250, WITH RESPECT TO ANY ONE STAMP, COIN OR OTHER INDIVIDUAL ARTICLE OR ANY ONE PAIR, STRIP, BLOCK, SERIES, SHEET, COVER, FRAME, CARD OR THE LIKE:

D. THIS COMPANY SHALL NOT BE LIABLE FOR A GREATER PROPORTION OF ANY LOSS ON PROPERTY NOT SPECIFICALLY SCHEDULED HEREIN, THAN THE TOTAL SUM INSURED ON SUCH UNSCHEDULED PROPERTY BEARS TO THE ACTUAL CASH MARKET VALUE THEREOF AT THE TIME SUCH LOSS SHALL HAPPEN.

6. **VALUATION:** THIS COMPANY SHALL NOT BE LIABLE FOR MORE THAN THE ACTUAL CASH VALUE OF THE PROPERTY AT THE TIME ANY LOSS OR DAMAGE OCCURS AND THE LOSS OR DAMAGE SHALL BE ASCERTAINED OR ESTIMATED ACCORDING TO SUCH ACTUAL CASH VALUE WITH PROPER DEDUCTION FOR DEPRECIATION, HOWEVER CAUSED, AND SHALL IN NO EVENT EXCEED:

A. WHAT IT WOULD COST TO REPAIR OR REPLACE THE SAME WITH MATERIAL OF LIKE KIND AND QUALITY, OR

B. THE APPLICABLE AMOUNT OF INSURANCE SET OPPOSITE THE RESPECTIVE ARTICLE COVERED HEREUNDER, WHICHEVER IS LESS.

7. **Loss Clause:** Any loss hereunder shall not reduce the amount of this endorsement, except in the event of payment of claim for total loss of an item specifically scheduled hereon. If claim is paid for total loss of one or more scheduled items, the unearned premium applicable to such items will be refunded to the Insured or applied to the premium due on item(s) replacing those on which the claim was paid.

8. **PAIR, SET OR PARTS.** IN THE EVENT OF LOSS TO:

(A) ANY ARTICLE OR ARTICLES WHICH ARE A PART OF A PAIR OR SET, THE MEASURE OF LOSS TO SUCH ARTICLE OR ARTICLES SHALL BE A REASONABLE AND FAIR PROPORTION OF THE TOTAL VALUE OF THE PAIR OR SET, GIVING CONSIDERATION TO THE IMPORTANCE OF SAID ARTICLE OR ARTICLES, BUT IN NO EVENT SHALL SUCH LOSS BE CONSTRUED TO MEAN TOTAL LOSS OF THE PAIR OR SET; OR

(B) ANY PART OF PROPERTY COVERED CONSISTING, WHEN COMPLETE FOR USE, OF SEVERAL PARTS, THE COMPANY SHALL ONLY BE LIABLE FOR THE VALUE OF THE PART LOST OR DAMAGED

SHOPPING FOR AUTO INSURANCE

	Insurer 1	Insurer 2	Insurer 3
Company			
Renewal date			

	Limits		Premium ^a		
	Car 1	Car 2			
Public liability					
Bodily injury					
Property damage					
Medical expenses (no fault)					
Uninsured motorist protection					
Physical damage					
Comprehensive					
Deductible					
Collision					
Deductible					
Total annual premium					

^aTotal premium for coverage area, regardless of number of cars.

NAME _____

DATE _____

STATEMENT OF INCOME DISABILITY NEEDS

1 *Annual Living Expenses* _____

2 *Adjusted Annual Living Expenses*

Tax savings _____

Insurance premiums waived _____

Other _____

3 *Spouse's Income* _____

4 *Investment Income* _____

5 *Social Security Benefits* _____

6 **TOTAL ADJUSTMENTS** _____

7 *Net Annual Disability Income Needs* _____

SHOPPING FOR HEALTH INSURANCE

	<i>Insurer 1</i>	<i>Insurer 2</i>	<i>Insurer 3</i>
Medical Expense Coverage			
Company	_____	_____	_____
Limits	_____	_____	_____
Room and board	\$ _____	\$ _____	\$ _____
Surgical maximum	\$ _____	\$ _____	\$ _____
Hospital extras	\$ _____	\$ _____	\$ _____
Physician care	\$ _____	\$ _____	\$ _____
Major medical maximum	\$ _____	\$ _____	\$ _____
Deductible	\$ _____	\$ _____	\$ _____
Reinstatement provisions	_____	_____	_____
Annual premium	\$ _____	\$ _____	\$ _____

Disability Income Coverage

Company	_____	_____	_____
Monthly benefits			
Total disability	\$ _____	\$ _____	\$ _____
Partial disability	\$ _____	\$ _____	\$ _____
Maximum age			
Accident	_____	_____	_____
Illness	_____	_____	_____
Waiting period	_____	_____	_____
Annual premium	\$ _____	\$ _____	\$ _____

NAME(S) _____

DATE _____

EIGHT-STEP PROCEDURE

1 *Funeral, Administrative, and Estate Tax Expenses* _____

2 *Debt Resolution* (excluding home mortgage) _____

3 *Contingency Fund* (twice your monthly take-home pay) _____

4 *College Fund* _____

5 *NET ANNUAL LIVING EXPENSES*

A. Average annual living expenses _____

B. Spouse's average annual income _____

C. Average annual Social Security _____

D. Net annual income needs (A - B - C) _____

E. Number of years in period _____

F. Average annual investment rate factor (Table 9-1) _____

G. TOTAL NET INCOME NEEDS (D x F) _____

6 *TOTAL MONETARY NEEDS* (1 + 2 + 3 + 4 + 5G) _____

7 *TOTAL INVESTMENT ASSETS* _____

8 *Your Life Insurance Needs* (6 - 7) _____

SHOPPING FOR LIFE INSURANCE

	<i>Insurer 1</i>	<i>Insurer 2</i>	<i>Insurer 3</i>
Policy type	_____	_____	_____
Company	_____	_____	_____
Face amount	\$ _____	\$ _____	\$ _____
Net annual premium	\$ _____	\$ _____	\$ _____
Disability waiver of premium	\$ _____	\$ _____	\$ _____
Accidental death and dismemberment rider	\$ _____	\$ _____	\$ _____
Policy owner	_____	_____	_____
Beneficiary	_____	_____	_____
Dividend option ^a	_____	_____	_____

^aDividend code: (1) reduces premium, (2) accumulates with interest, (3) purchases paid-up additions, (4) purchases one-year term insurance, (5) paid in cash.



PACIFIC UNION
Bank & Trust Company
800 OAK GROVE, MENLO PARK, CA. 94025

DATE OF PREVIOUS STATEMENT		DATE OF THIS STATEMENT	
ACCOUNT NUMBER			
DISPOSITION CODE	NUMBER OF ENCLOSURES	PAGE NO.	

CHECKING ACCOUNT ACTIVITY (SEE REVERSE SIDE OF STATEMENT FOR IMPORTANT INFORMATION)

CHECKS AND OTHER DEBITS		DEPOSITS AND OTHER CREDITS		LOW BALANCE		AVERAGE BALANCE		SERVICE CHARGE	BEGINNING BALANCE		
NO	AMOUNT	NO	AMOUNT								
TRANSACTION DESCRIPTION			AMOUNT	DATE	TRANSACTION DESCRIPTION			AMOUNT	DATE	RUNNING BALANCE	DATE
</											

STATEMENT RECONCILIATION

STATEMENT BALANCE	\$	
ADD- DEPOSITS MADE BUT NOT SHOWN ON THIS STATEMENT		
TOTAL	\$	
SUBTRACT- CHECKS OUTSTANDING		
TOTAL- SHOULD AGREE WITH YOUR CHECK BOOK BALANCE	\$	

CHECKS OUTSTANDING		
CHECK NUMBER		AMOUNT
TOTAL-	ENTER IN THE SPACE PROVIDED ABOVE	\$



PACIFIC UNION Bank & Trust Company

FEDERAL TRUTH IN LENDING DISCLOSURE STATEMENT

INSTRUCTIONS:

1. ORIGINAL: Bank Copy
2. DUPLICATE: Customer Copy

TO LOAN APPLICANT(S):

The following disclosures regarding the proposed loan of \$_____ you have requested are given in compliance with the Federal Truth in Lending Act

Date _____

Loan Number _____

1. Loan

a. Amount to borrow \$_____

b. Charges to be Financed (1) _____

(est) \$_____

(2) _____

(est) \$_____

(3) _____

(est) \$_____

(4) _____

(est) \$_____

(5) _____

(est) \$_____

(6) _____

(est) \$_____

Total Charges to be Financed (est) \$_____

PRINCIPAL AMOUNT OF NOTE (a + b) _____

(est) (1) ▶ \$_____

2. Less: Prepaid Finance Charge _____

(Itemized in 4a below)

(est) (2) ▶ \$_____

3. Amount Financed _____

(1) - (2)

(est) (3) ▶ \$_____

4. FINANCE CHARGE

Includes: a. Prepaid Finance Charge

(1) _____

(est) \$_____

(2) _____

(est) \$_____

(3) _____

(est) \$_____

(4) _____

(est) \$_____

(5) _____

(est) \$_____

(6) _____

(est) \$_____

(7) _____

(est) \$_____

(8) _____

(est) \$_____

a. Total Prepaid Finance Charge

(est) ▶ \$_____

b. Not Prepaid

(1) Interest (est) from 19____ \$_____

to 19____

(2) Minimum Charge \$_____

(3) \$_____

(4) \$_____

(5) \$_____

(6) \$_____

(7) \$_____

(8) \$_____

b. Total Not Prepaid

(est) ▶ \$_____

(4a + 4b) **FINANCE CHARGE** (est) (4) ▶ \$_____

5. ANNUAL PERCENTAGE RATE _____%

6. Total of Payments _____

(3) + (4) Total of Payments (est) ▶ \$_____

Repayable in _____ instalments as follows \$_____ on _____

and _____ successive

instalments of \$_____

beginning _____

and on _____

the entire principal balance and unpaid interest is due.

The Bank does not intend to refinance any balloon payment shown. Payments, when received, will be applied as follows: first to pay the interest then due; next, to any late charge then due; any remaining amount to the repayment of the principal balance.

7. Late Payments

Interest at _____% per year continues to be calculated on unpaid principal. You will be charged a late charge of 5% (\$1.00 minimum, \$5.00 maximum) on any portion of any installment not received by the bank by the first banking day which is at least ten (10) days after the due date. For the sole purpose of determining whether a late charge will be assessed, and without affecting the actual application of any payment in the manner described in the Total of Payments section of this statement, the following will apply: (1) if this loan is secured by a Deed of Trust on real property (9a below) any payment made will be deemed applied to the most recent installment due; (2) if this loan is not so secured any payment made will be deemed applied to the oldest unpaid installment. In the event of default in a payment required on this loan or on any sum you may now or hereafter owe the Bank, the Bank may, at its option, without notice or demand, declare the entire principal balance of this loan plus accrued interest immediately due and payable. Also, payable are: (1) a reasonable collection charge if it is necessary to refer collection to the Bank's collection facilities or to a collection agency; and (2) reasonable attorney fees and court costs in the event of suit.

8. Other Charges (Not part of finance charge and not financed)

a _____ (est) \$ _____ b _____ (est) \$ _____
c _____ (est) \$ _____ d _____ (est) \$ _____
Total (est) \$ _____ to be paid by you to the appropriate public authority after full

repayment of all obligations secured by the collateral described in the Security portion of this statement.

9. Security

The security for this obligation is:

a ☐ Deed of Trust covering real property located at _____ and rights related thereto, more particularly described in the attached copy of a Deed of Trust which contains, among other things, assignments of (1) rents, issues and profits, (2) insurance return premiums and proceeds, and (3) all rights to compensation, awards, damages, rights of action and proceeds relating to any taking or damage to that real property. The Deed of Trust will also cover any additional property described therein and any after-acquired property so attached to the real property or to any building now or hereafter on that real property as to become a part thereof. The Deed of Trust will also secure the performance of your obligations thereunder and any payments made by the Bank pursuant to the terms thereof.

b ☐ Security Agreement covering the property described as follows: _____ and rights thereto,

such property and rights more particularly described in the attached copy of the Security Agreement. The Security Agreement will also cover all equipment, parts and accessories now or hereafter owned by the owner of this property and installed in or affixed to the property and any additional and after-acquired property (not including consumer goods acquired more than ten (10) days after the loan is made, unless those goods are installed in or affixed to the property) as described therein and contains an assignment, as security, of the proceeds, including return premiums, of any insurance required by the Bank thereunder on the property. The Security Agreement will also secure the performance of your obligations thereunder, any payments made by the Bank pursuant to the terms thereof and other and future indebtedness as provided therein. Regardless of any other existing agreement between the Bank and you or any third party, the loan will not be secured by any contractual lien except as indicated above. However, the loan may be secured by a Banker's lien, arising under California Civil Code § 3054 upon any property while it is in the Bank's possession. If the balance of the loan, any payments thereon, or any related obligation becomes due, the Bank may, where permitted by law, without notice or demand, under its "right of Setoff", setoff the amount then due to the Bank against any amounts due from the Bank, including amounts on deposit to any one or more of you.

10. Prepayment

You may prepay any portion of the principal balance at any time, thereby lowering the balance upon which interest is calculated. Upon full prepayment any unpaid earned interest, plus any amount needed to bring the Bank's total earned interest to \$ _____, will be collected. If you elect to obtain credit life or credit life and disability insurance through the Bank, the unearned portion of the premium as of the time of prepayment, calculated by the Rule of 78, will be refunded.

11. Property and Flood Insurance

Property, including flood insurance, if written in connection with this loan, may be obtained by you through any person of your choice. The insurer must be acceptable to the Bank.

☐ Property insurance, other than flood insurance, is required. If obtained through the Bank the estimated cost will be \$ _____ for _____ months.
☐ Insurance against flood hazards is required. If obtained through the Bank the estimated cost will be \$ _____ for _____ months.

12. Credit Life & Disability Insurance are not required to obtain this loan.

The cost of the insurance checked below (available by separate application) is \$ _____ for the term of the loan.

☐ Single Credit Life and Single Disability (SD) ☐ Single Credit Life Only (SL) ☐ Joint Credit Life and Single Disability (JD) ☐ Joint Credit Life Only (JL)

I Want the Insurance Checked Above

_____, Date _____ 19_____, Signature of Applicant to be insured
_____, Date _____ 19_____, Signature of Co-Applicant to be insured for Joint Credit Life

NOTE: "(est)" means estimated.

PACIFIC UNION BANK & TRUST COMPANY

I have received a copy of this disclosure statement and have not yet signed any documents evidencing the proposed loan.

By _____, Signature

_____, Date _____ 19_____, Loan Applicant

_____, Date _____ 19_____, Loan Applicant

IC 408 5/78

BORROWER'S/BUYER'S INSTRUCTIONS

TRANSAMERICA TITLE INSURANCE COMPANY

Date _____
Escrow Number _____

Enclosed herewith are:

CHECK in the amount of \$ _____ CASH in the amount of \$ _____ PROMISSORY NOTE and DEED OF TRUST _____

(Documents and terms thereof have been examined and approved by Borrower/Buyer)

You are hereby authorized to deliver and/or record all of said documents and disburse said funds, together with the proceeds of any deed of trust mentioned below, on account of the purchase price for the real property described in your above numbered escrow and on account of the other costs, fees and adjustments in that connection, when you can issue your ☐ Standard Coverage form Title Insurance Policy in the amount of \$ _____, insuring title as vested in the name of: _____

☐ Standard ☐ ALTA policy of title insurance for not less than the amount of the enclosed Deed of Trust, with _____ indorsement form No. _____ attached, insuring said Deed of Trust to be a lien or charge upon the real property described therein,

SUBJECT TO: COUNTY and/or CITY TAXES not delinquent; BONDS and/or SPECIAL ASSESSMENTS not delinquent; and COVENANTS, CONDITIONS, RESTRICTIONS, RIGHTS OF WAY, EASEMENTS and RESERVATIONS now of record.

DEED of TRUST in favor of _____

DEED of TRUST in favor of _____

Pro-rate as of _____ (based on a 30-day month); ☐ Real Property Taxes (based on the latest available tax bills);

☐ Fire Insurance Premiums; ☐ Interest on Existing Loan; ☐ Rents (based on statements provided by Seller); ☐ Upkeep Charge.

Credit to Seller ☐ Existing loan trust fund. Credit to Buyer ☐ Security deposits.

LINE	ESTIMATED STATEMENT	DEBITS	CREDITS
101.	Contract sales price		
102.	Personal property		
103.	Borrower's/Buyer's charges (Ln. 1400 - Page 2)		
104.			
105A.			
105B.			
105C.			
105D.			
105E.			
105F.			
105G.			
105H.			
	ADJUSTMENTS FOR ITEMS PAID BY SELLER IN ADVANCE		
106.	City/town taxes \$ _____ to _____		
107.	County taxes \$ _____ to _____		
108.	Assessments \$ _____ to _____		
109.			
110.			
111.			
112.			
	AMOUNTS PAID BY OR IN BEHALF OF BORROWER/BUYER		
201.	Deposit or earnest money		
202.	Prin. amt. of new loans		
203.	Existing loan(s) taken subject to		
204.			
205.			
206.			
207.			
208.			
209.			
	ADJUSTMENTS FOR ITEMS UNPAID BY SELLER		
210.	City/town taxes \$ _____ to _____		
211.	County taxes \$ _____ to _____		
212.	Assessments \$ _____ to _____		
213.			
214.			
215.			
216.			
303.	Balance due to/ from this escrow (estimated)		

L. SETTLEMENT CHARGES

LINE		AMOUNT
704.	COMMISSION	
705.		
800.	ITEMS PAYABLE IN CONNECTION WITH LOAN:	
801.	Loan Origination % to	
802.	Loan Discount % to	
803.	Appraisal Fee to	
804.	Credit Report to	
805.	Lender's inspection fee	
806.	Mortgage Insurance application fee to	
807.	Assumption/refinancing fee	
808.	Tax Service to	
809.		
810.		
811.		
900.	ITEMS REQUIRED BY LENDER TO BE PAID IN ADVANCE:	
901.	Interest from to @ \$ /day	
902.	Mortgage insurance premium for mo. to	
903.	Hazard insurance premium for yrs. to	
904.	for yrs. to	
905.	Reconveyance fee	
1000.	RESERVES DEPOSITED WITH LENDER FOR:	
1001.	Hazard insurance mo. @ \$ /mo.	
1002.	Mortgage insurance mo. @ \$ /mo.	
1003.	City property taxes mo. @ \$ /mo.	
1004.	County property taxes mo. @ \$ /mo.	
1005.	Annual assessments mo. @ \$ /mo.	
1006.	mo. @ \$ /mo.	
1007.	mo. @ \$ /mo.	
1008.	mo. @ \$ /mo.	
1100.	TITLE CHARGES:	
1101.	Settlement or closing fee	
1102.	Abstract or title search	
1103.	Title examination	
1104.	Title insurance binder	
1105.	Document preparation	
1106.	Notary fees	
1107.	Attorney's fees	
1108.	Title insurance to	
1111.	Indorsement	
1112.		
1113.		
1200.	GOVERNMENT RECORDING AND TRANSFER CHARGES	
1201.	Recording charges: Deed \$: Mortgage \$ Releases \$	
1202.	City county tax/stamps: Deed \$: Mortgage \$	
1203.	State tax/stamps: Deed \$: Mortgage \$	
1204.		
1300.	ADDITIONAL SETTLEMENT CHARGES	
1301.	Survey	
1302.	Pest inspection	
1303.		
1304.		
1305.		
1400.	TOTAL SETTLEMENT CHARGES (entered on line 103)	

These instructions are effective _____ and thereafter until revoked by written demand on you by the undersigned or any one of them. I hereby agree to pay all my proper costs and fees, including any adjustments, and request you to remit balance to me at the address shown below.

If you are the prevailing party in any action or proceeding between you and some or all of the parties to this escrow, you shall be entitled to all costs, expenses, and reasonable attorney's fees expended or incurred in connection therewith. If you are required to respond to any legal summons or proceedings not involving a breach or fault upon your part, the parties to this escrow jointly and severally agree to pay all costs, expenses, and reasonable attorney's fees expended or incurred by you, and the parties hereto further agree to indemnify you against all loss and expense in the said action or proceeding.

NAME(S) _____

DATE _____

WORKSHEET FOR PLANNING INVESTMENTS AND ACHIEVING GOALS

A	B	C	D	E	F1	F2	G	H
Goal	Amount Needed	Years	Inflation Factor ^a	Adjusted Amount Needed (B X D)	Return Factor from Table A ^a	B ^b	Lump-Sum Investment ^a (E ÷ F1)	Annual Investment ^b (E ÷ F2)
							_____	_____
Amount remaining							_____	_____
Amount remaining							_____	_____
Amount remaining							_____	_____
Amount remaining							_____	_____
Amount remaining							_____	_____
Amount remaining							_____	_____
	(To be computed in Chapter 21)			(To be computed in Chapter 21)			_____	_____
Amount remaining							_____	_____

^aRefer to compound interest Table A.^bRefer to compound interest Table B.

OVERVIEW OF INVESTMENT TYPES TREATED IN CHAPTERS 16 THROUGH 20

Group I: Fixed Dollar Investments

Characteristics	Primary Uses	Classification			Best Opportunities
		Investment Opportunity	Important Advantage	Major Disadvantage	
Interest or dividends earned on a fixed amount of principal	To hold emergency funds	Savings account or credit union	High liquidity	No inflation protection	Savings and loan accounts, U.S. savings bonds, insured credit union accounts, life insurance (for forced savings), money market mutual funds
	To hold temporary or short-term funds for buying certain items or making other investments	U.S. savings bond	No state taxes; deferred federal taxes	No inflation protection	
		Life insurance	Forced savings	Lowest rate of return	
		Fixed annuity	Lifetime income	No inflation protection	

Group II: Marketable, Fixed Income Investments

Characteristics	Primary Uses	Classification			Best Opportunities
		Investment Opportunity	Important Advantage	Major Disadvantage	
Fixed income, but can have price fluctuations	Conservative investments with better yields than those available in Group I (without much more management) For two- to five-year investments needs if Group III prospects uncertain	Preferred stock (not convertible)	High yield (sometimes)	Stock prices forced down by rising interest rates with no maturity date redemption	Up to 15-year maturity corporate or municipal bonds, second deeds of trust
		Corporate bonds Maturities of around five years or less	High yield and safety	No inflation protection plus price fluctuation problems	
		Maturities of 10 to 15 years	High yield	Same as for corporate bonds	
		Municipal bonds	Tax advantage to investors in brackets over 40 percent	Risk of doing business with a poor broker	
		Second deeds of trust	Highest yield and small price fluctuation		

Group III: Equity Investments

Characteristics	Primary Uses	Classification			Best Opportunities
		Investment Opportunity	Important Advantage	Major Disadvantage	
Price fluctuations Right to income from an asset Possible hedge against inflation	For all long-term investments (three years or more) to obtain high yields	Common stock	Very high potential return	Significant management required	Common stocks and convertibles (for active investor)
		Mutual funds	High potential return; little management required	Difficult to outperform market	Mutual funds and real estate syndicates or trusts (for inactive investor)
		Variable annuity	Lifetime income: no management required	Same management for life	Carefully selected variable annuity (for retirement)
		Convertible bonds and preferred stock	Higher current income than from common stocks	Significant management required; sometimes overpriced relative to common stocks	
		Real estate syndicates and trusts	High yield; tax shelter; little management required	Requires careful initial selection; lack of liquidity	

15-2 CONTINUED

NAME(S) _____

DATE _____

RETIREMENT LIVING EXPENSE NEEDS

1 Age at Retirement

Husband _____
 Wife _____

2 Basic Living Expenses

	Month	Year
Housing	_____	_____
Utilities	_____	_____
Repairs	_____	_____
Insurance	_____	_____
Taxes	_____	_____
Other _____	_____	_____
Rent or mortgage payments	_____	_____
Food	_____	_____
Clothing, personal care		
Him	_____	_____
Her	_____	_____
Gifts, contributions	_____	_____
Transportation		
Gas	_____	_____
Repairs	_____	_____
Licenses	_____	_____
Insurance	_____	_____
Auto payments or purchase	_____	_____

Medical

Doctor _____
 Dentist _____
 Medicines _____
 Insurance _____

Taxes (personal income) _____

TOTAL _____

3 Recurrent Extra Expenses

Gardening _____
 Travel _____
 Other _____

TOTAL _____

4 Total Annual Living Expenses

5 Expected Number of Years of Retirement

6 Total Living Expenses during Retirement

7 One-Time Costs

8 Total Funds Needed at Retirement

9 Years to Retirement

10 Inflation Factor

11 Total Inflated Living Expenses at Retirement

NAME(S) _____

DATE _____

RETIREMENT INVESTMENT NEEDS

1 Age at Retirement

Husband _____
Wife _____

2 Monthly Social Security Benefits

Worker at 65 _____
Spouse at 65 _____
TOTAL _____

3 Annual Income from Social Security

4 Inflation Factor

**5 Inflated Annual Income
from Social Security**

6 Annual Pension Benefits

Worker _____
Spouse _____
TOTAL _____

**7 Total Estimated Annual Income from
Social Security and Pension**

8 Expected Number of Years of Retirement

**9 Total Estimated Retirement Income from
Social Security and Pension**

10 Total Inflated Living Expenses

11 Investment Needed at Retirement

12 Profit from Sale of Home (after taxes and selling costs)

Current market value of home _____
Inflation factor _____
Market value at retirement _____

13 Adjusted Total Investment Needed at Retirement

14 Investment Strategy Needed

Amount to be invested yearly _____
After-tax interest _____